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IN THE

Supreme Court of the United States

OCTOBER TERM, 1940

No. 466

DONALD N. GILBERT, HAROLD C. YEAGER and GEORGE A. CAREY, constituting the First Mortgage Bondholders' Protective Committee for The Peoria and Eastern Railway Company's First Consolidated Mortgage 4% Bonds due April 1, 1940,

Petitioners,

against

THE PEORIA AND EASTERN RAILWAY COMPANY and WILLIAM CARNEGIE EWEN, LEWIS L. CLARKE and MAURICE D. ADAMS, as the Peoria and Eastern Railway Company Income Bondholders' Protective Committee,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK AND MOTION TO DISPENSE WITH PRINTING AND SERVICE OF PORTIONS OF RECORD AND FOR THE PRINTING OF A JOINT RECORD

DONALD N. GILBERT, HAROLD C. YEAGER and GEORGE A. CAREY, Petitioners,
By SCRIBNER & MILLER,
ALFRED E. SMITH, JR.,
Solicitors of Petitioners.

MARK HYMAN,
Counsel for Petitioners.

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MOTION TO DISPENSE WITH PRINTING AND SERVICE OF PORTIONS OF RECORD AND FOR THE PRINTING OF A JOINT RECORD 44

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Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

TO THE HONORABLE, THE CHIEF JUSTICE OF THE UNITED STATES AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES:

DONALD N. GILBERT, HAROLD C. YEAGER and GEORGE A. CAREY, as a Committee for Peoria & Eastern's First Consolidated Mortgage 4% Bonds, your petitioners above-mentioned, intervened herein pursuant to order of the District Court dated May 8, 1940.

This is an application for a writ of certiorari to review the final decree of the United States District Court for the Southern District of New York, convened as a special court of three judges, which approved and confirmed a plan of railroad adjustment; all pursuant to the Railroad Adjustments Act, being Chapter 15 of the Bankruptcy Act (§§ 700-755, added July 29, 1939).

Jurisdiction

The jurisdiction of the Court to grant the writ of certiorari applied for rests upon § 745 of said chapter (11 U. S. C. A. 1245), reading as follows:

> "Any final order or decree of the special court may be reviewed by the Supreme Court of the United States upon application for certiorari made by any person affected by the plan who deems himself aggrieved within sixty days after the entry of such order or decree, pursuant to the provisions of the Federal Judicial Code."

Opinion Below

The opinion below is annexed hereto as Appendix A.

Statute Involved

The pertinent provisions of the Railroad Adjustments Act (Bankruptcy Act, Chapter 15) are annexed hereto as Appendix B.

The Questions Presented

(a) Whether a twenty-year extension of the mortgage debt is an arrangement, temporary only, for meeting such debt; within the meaning of said Chapter 15.

(b) Whether a junior creditor-stockholder may appropriate future earnings to his debt instead of applying them to meet the matured mortgage debt.

(c) Whether under said Chapter 15 a twenty-year extension of the mortgage debt may be forced without showing that the railroad had even attempted to refinance the debt.

(d) Whether a railroad with inadequate capital and earnings is meeting its debts with only a temporary extension when it forces a twenty-year moratorium with no *interim* part payments.

(e) Whether the Plan is fair and equitable or displaces the legal priority of the mortgage debt over junior creditors and stockholders.

(f) Whether equitable relief against strict foreclosure could be afforded the parent corporation without first determining whether it had diverted or wasted the assets of the completely-dominated subsidiary.

(g) Whether a parent corporation, within the "Instrumentality Rule" can compete with and displace prior lienors.

(h) Whether the overdue mortgage debt was entitled to a sinking fund out of earnings.

(i) Whether accounts which are the product of retired and depreciated rolling stock which is covered by the mortgage should be applied to or for the security of the overdue mortgage debt.

(j) Whether a proper accounting by the parent corporation was a condition precedent to granting it the enormous advantages of the Plan, in view of the charges of diversion and waste of assets.

Summary Statement

The decree below dated July 23, 1940, entered on July 29, 1940, approved and confirmed the "Plan of Adjustment under Chapter 15 of the Bankruptcy Act" of The Peoria and Eastern Railway Company, dated January 10, 1940.

(a) The Railroad and its First Consolidated Mortgage

On February 22, 1890, there was a foreclosure and reorganization of the Ohio, Indiana and Western Railway Company, running from Springfield, Ohio, to Peoria, Illinois, whereunder the Indiana and Illinois Divisions (from Indianapolis, Indiana, to Pekin, Illinois) were deeded to The Peoria and Eastern Railway Company, and whereunder the Springfield Division (from Indianapolis, Indiana, to Springfield, Ohio) was deeded to the Cleveland, Cincinnati, Chicago and St. Louis Railway Company (the "Big Four"), subject to a purchase money lien of $5,000,000 in favor of the mortgage trustee and bondholders hereinafter mentioned (Findings No. 5, 6).

Simultaneously, an Operating Agreement was made for the Peoria & Eastern road with the Big Four, which ever since has owned 50+% of the stock of Peoria & Eastern (Findings No. 9, 16, 17, 51).

Simultaneously, an indenture of mortgage was executed from Peoria & Eastern to Central Trust Company of New York and Charles W. Fairbanks, Trustees, embracing the Indiana and Illinois Divisions and trackage rights into Indianapolis and Peoria, and covering also said $5,000,000 purchase money lien upon the Springfield Division of the Big Four; all in trust for the First Consolidated Mortgage Bondholders of Peoria & Eastern. Of such bonds $8,376,000 are outstanding and publicly owned, and $500,000 are pledged with the Securities Corporation of the New York Central (Findings No. 8, 12, 13, 31).

By January 2, 1930, the New York Central Railroad Company had acquired 96% of the Big Four stock; and on said date acquired the Big Four's rights under the foregoing operating agreement, and also acquired a lease on the Springfield Division and other lines of the Big Four (Findings No. 18, 19). The line of the Peoria & Eastern is part of the main line of the New York Central from the East, and constitutes the entrance of the New York Central into the Peoria gateway, which is "recognized as a major western gateway along with Chicago and St. Louis" (J. A. Keegan, Gen. Freight Agent, N. Y. Central).

Under the aforesaid Operating Agreement, Big Four covenanted to make good any deficiency in operating income necessary to pay the interest on the first mortgage bonds and any prior lien bonds of Peoria & Eastern. Said interest at that time amounted to $412,200 annually. Big Four guaranteed that the net earnings "so actually applied to the payment of said interest shall be not less than $412,200 in each and every year of the fifty years for which it by these presents undertakes the use and occupation of the said * * * railroad". By Paragraph Fifth of the Agreement, Big Four agreed to "look only to such future net earnings * * * as shall not be required for the payment of said interest on said prior bonds and on said first consolidated mortgage bonds, and hereinabove guaranteed by it, for the reimbursement to it of any sums it may advance in compliance with its aforesaid covenants and agreements" (Ex. 26).

(b) Present Status of Peoria & Eastern

On April 1, 1940, the following of Peoria's obligations matured (Finding No. 31):

1. The $846,000 outstanding bonds prior to the First Consolidated Mortgage Bonds.

2. The First Consolidated 4% Mortgage Bonds, aggregating $8,376,000 publicly held which were secured by a mortgage on Peoria & Eastern's railway and by the said $5,000,000 purchase money lien.

3. Its 5% promissory note to the Securities Corporation of the New York Central, secured by $500,000 of its First Consolidated Mortgage Bonds and by its 1,730 shares of capital stock of Peoria & Pekin Union Railway Co.

On April 1, 1940, the aforesaid Operating Agreement expired by its terms (Finding No. 33). New York Central and Big Four claimed that Peoria owed $2,485,482.58 (intercompany debt) advances purportedly made thereunder. Admittedly, New York Central owes Peoria & Eastern $1,290,296.84 held in the equipment retirement and equipment depreciation accounts (Finding No. 29).

Peoria & Eastern's $4,000,000 income mortgage 4% bonds are not due until April 1, 1990. Interest thereon is not payable until after payment has been made of interest on the First Consolidated Mortgage Bonds and of both interest at 6% and principal on the aforesaid intercompany debt (Finding No. 11).

There also matured on April 1, 1940 the First Mortgage Bondholders' aforesaid $5,000,000 purchase money lien on Big Four's Springfield Division (Finding No. 32). While Big Four was not obligated to pay the $5,000,000, its failure so to do constituted a default which gave the bondholders' trustee the right to take possession of the said Springfield Division and to foreclose the mortgage thereon (Finding No. 13). Moreover in 1919, the Big Four covenanted with its own mortgage bondholders to pay said lien (Finding No. 15).

(c) The Plan of Adjustment (Ex. 5)

To meet its maturities, Peoria & Eastern proposed its Plan of Adjustment of January 10, 1940. The Plan is predicated upon payment by the Big Four of $5,000,000 to discharge the said purchase money lien. On April 1, 1940, Big Four paid the said sum by New York Central's check to the Trustee for the First Mortgage Bondholders, conditioned upon the Plan's becoming effective (Ex. 46). The Plan provides for the application of the $5,000,000 as follows:

1. Payment in full of the $846,000 bonds prior to the First Consolidated Mortgage Bonds.
2. Payment of $384,500 to the Securities Corporation of the New York Central on account of Peoria & Eastern's note to it of $500,000, secured by $500,000 of First Consolidated Mortgage Bonds, leaving $115,500 of such bonds.

3. Payment of $3,769,200 on account of the $8,376,000 principal amount of Peoria & Eastern's First Consolidated Mortgage Bonds ($450 for each $1,000 bond), reducing such outstanding bonds to $4,606,800.

4. The remaining $300 is to be used to purchase Peoria & Eastern's First Consolidated Mortgage Bonds at lowest possible prices by the Trustee.

The Plan further provides for:

5. The extension of the maturity of the remaining $4,722,300 First Consolidated Mortgage Bonds to April 1, 1960 at 4% per annum without any amortization or sinking fund. Peoria & Eastern is to pledge as additional security for these extended bonds its 1,730 shares of Peoria & Pekin Union Railway Co. capital stock.

6. The Operating Agreement is to be purportedly extended to April 1, 1960, and the intercompany debt aggregating with interest $2,506,192 allegedly owed by Peoria & Eastern under the old Operating Agreement

"shall continue their existing status under the Operating Agreement during the extended term of such Agreement" (Plan Div. II, Paragraph 7; Div. III, Paragraph 7; $2,485,482.58 on December 31, 1939).

The Plan purports to make no change in Peoria & Eastern's $4,000,000 of 4% non-cumulative income bonds due April 1, 1990, which by their terms are subordinate to the First Consolidated Mortgage Bonds and also to the operating agreement. The Plan leaves unaffected the outstanding capital stock totaling $9,999,200.

(d) Valuation and Indebtedness

The basic valuation by the Interstate Commerce Commission of the Peoria & Eastern's land, road and equipment, with net additions and betterments to December 31, 1939, is $10,836,396.86 (as against book value of $20,616,896.01) (Finding 28, Exhibit 35).

There is no evidence of value except said valuation of the Interstate Commerce Commission. Using that as a basis, the situation created by the "Proposed Plan of Adjustment of Peoria & Eastern" is as follows (it being remembered that the Plan proposes to pay off the $5,000,000 purchase money lien upon the Springfield Division and reduce the liabilities by $5,000,000) (Ex. 35):

ASSETS

Road and equipment	$10,836,396.86
Miscellaneous physical property, deferred assets and miscellaneous investments in affiliated companies	210,439.83
Unadjusted debits, equipment retirement and depreciation accounts	1,290,296.84
Total Assets	$12,337,133.53

LIABILITIES

First Mortgage Bonds to be outstanding upon consummation of Plan	$4,722,300.00
Junior Income Bonds	4,000,000.00
Non-negotiable debt to New York Central and Big Four	2,485,482.58
Capital Stock	9,999,200.00
Total Liabilities	$21,206,982.58

This would show a balance sheet deficit for Peoria & Eastern, after the adjustments contemplated by the Plan, of $8,869,849.05.

(e) Earnings

In considering Peoria & Eastern's income, it must be remembered that the $200,000 annually heretofore received on the $5,000,000 purchase money lien upon the Springfield Division, which lien is to be paid off under the Plan, must not be included. As so adjusted, the available net earnings for the past ten years have been as follows (cents omitted) (Ex. 33½):

1930	$ 69,287
1931	34,047
1932 (Deficit)	*32,593*
1933	225,586
1934	170,233
1935	234,897
1936	452,115
1937	166,887
1938	129,987
1939	252,566.

The average of such earnings is $170,301.20. Under the Plan, the interest requirements upon the obligations presently to be outstanding are as follows:

First Mortgage Bonds	$188,892.00
Non-negotiable debt to New York Central and Big Four, principal sum $1,814,-956.24 at 6% interest, cumulative, if earned	108,897.37
Income Bonds, 4%, non-cumulative, if earned	160,000.00
Total income requirements	$457,789.37

before anything can be paid on the principal of the over-due First Consolidated Mortgage Bonds.

(f) Peoria & Eastern as an Instrumentality—

Peoria & Eastern is a mere instrumentality of, first, the Big Four, and, now, the New York Central. "By reason of its ownership of a majority of the stock of the petitioner [Peoria & Eastern] the Big Four and/or the New York Central have completely dominated and controlled the affairs and business of the petitioner" and "enjoyed unrestricted control over the solicitation of traffic on petitioner's property" (Findings 18, 22).

The balance sheets of Peoria & Eastern for the last ten years (Ex. 35) indicate that it has never had any cash, bank account or quick assets, even in the year 1936, when it earned $182,558 net over fixed charges. Practically all directors are officers or employees of the New York Central (Exs. D, E and F).

The proposed twenty years' extension of the Operating Agreement lacks any evidence of negotiations with anyone on behalf of Peoria & Eastern, either as to the term or conditions of renewal.

This agreement proposes to continue as a charge against future earnings, accumulated operating deficits of the past fifty years with 6% interest, and future operating deficits cumulative, also at 6% interest. (Plan, pp. 18, 23; Extension of Operating Agreement, p. 2, par. First.)

The total traffic revenue over the lines of Peoria & Eastern for the year ended June 30, 1939, was $4,412,348, of which New York Central received $2,193,162, and Peoria & Eastern, $2,219,186 (I. C. C. Report, p. 19). There is no evidence of any bargaining as to the division of freight rates.*

Likewise, except for a brief period, there was no outsider to supervise the accounts. In 1919, after an investigation, the Big Four reduced its charges against Peoria & Eastern from $324,286.02 to $24,912.65; and between 1925 and 1932, while a representative of the income bondholders was upon the Board, charges were reversed against Peoria & Eastern to the extent of $755,629 (Ex. Y). During the twenty years from December 31, 1919 to December 31, 1939, these charges mounted from $24,912.65 to $2,485,482.58 (Ex. I).

(g) The Equipment Accounts

By the Operating Agreement, the Big Four (and New York Central as its successor) agreed to provide and furnish, keep and maintain, at its own cost and expense, all rolling stock and equipment in good working order, and restore or renew all parts thereof as may be necessary to that end (Paragraph First). In lieu thereof, New York Central set up against itself an "Equipment Retirement Account", which has averaged for the past five years $516,225 (Ex. 35). The Plan (Paragraph 6, p. 23) provides that Big Four will replace equipment "which has been retired and not replaced, or has become unserviceable for further use, with suitable equipment * * *", equal

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* The brief below on behalf of income bondholders states at page 35:

> "In the instant case, to employ the language of the Examiner of the Commission before whom the proceedings were heard, 'There was no one to bargain with' ".

to the $516,837.38 appearing in that account as of December 31, 1939.

The Interstate Commerce Commission report shows that this fund "of approximately $515,000" will restore to Peoria & Eastern 400 cars at an annual saving of $106,526 on a *per diem* basis (pp. 17-18). The actual *per diem* cost for equipment rents for 1939 was $142,217.36, as against the estimated cost of $35,657 which would follow the above restoration of cars (Exs. 33½, 41).

This annual loss of $106,000 was partially palliated by the charge of 6% upon the equipment retirement account which the New York Central charged against itself, which would amount on the average to $30,973.50 per year. But the New York Central apparently offset it against an equivalent of interest on its advances; which advances and interest thereon, however, it could not obtain except from surplus profits of which there were none, and which in no event could it recoup as against the First Consolidated Mortgage Bondholders (Supplement of February 22, 1890, to Operating Agreement (Ex. 27) which latter was assigned to the Mortgage Trustee by Indenture dated March 25, 1890, Findings 13, 27).

The Plan states that the New York Central "is holding for the benefit of the Peoria and Eastern" both the above equipment retirement account and $768,710.44 in an equipment depreciation account" (p. 18; $773,459.46 on Dec. 31, 1939, Ex. 35). The equipment depreciation account is not disposed of by the Plan. That account for the past five years has averaged $635,843.74, and if only a part thereof had been used to restore the depreciated rolling stock, there would not at any time throughout the ten-year period have been any net equipment rents. The total of such rents for the ten-year period constituted a direct loss which was proximately caused by the violation of the operating agreement and the mortgage indenture and amounted to $1,316,077.78 (Exs. 33½ and 35).

(h) Equipment under the First Consolidated Mortgage

The granting clause of the First Consolidated Mortgage Indenture of February 22, 1890 (Ex. 20, p. 6), covers "all engines, cars, coaches and other rolling stock", with a provision in Paragraph Eighth, that the trustees under the mortgage may release property no longer needed and require the proceeds to be applied like insurance money; that is to say (p. 13):

> "All proceeds of such insurance to be paid over to and held by said Central Trust Company of New York as additional security until the same shall be applied by direction of the Railway Company either in restoring or renewing the parts of the mortgaged premises so injured or destroyed, or in improvements thereof * * *."

As to the interest thereon, the earning statements (Exhibit 33½) do not indicate any such payment. On the contrary, the New York Central charged interest on net intercompany account indicating that the interest on the equipment account was merely offset against the claimed interest on the "advances" account (Finding 27). This was not permissible because

(a) such advances were to be repayable only from net profits and there were no net profits any year for the past ten years except 1936 (Exs. 33½, 35); and

(b) by virtue of the "Supplement to Operating Agreement", also dated February 22, 1890, the provision permitting the Big Four to recoup for its advances under its guarantee of interest on the bonded indebtedness was to be effective against all parties "other than the holders of the First Consolidated Mortgage Bonds and the Trustees of the mortgage securing the same" (Ex. 27).

Apparently, the New York Central has sought to avoid this provision of the "Supplement to Operating Agree-

ment" by charging betterments to a separate account totaling $1,806,493.18 plus $522,517.24 interest thereon (Finding No. 27) and not treating betterments as part of the expenses of operation and maintenance; although by Paragraph Third of the Operating Agreement, expenses of operation and maintenance are defined to include "repairs, renewals and reasonable betterments".

It is significant that the "Supplement to Operating Agreement" is dropped completely in the scheme under the Plan of Adjustment, and is not part of the "Extension of the Term of the Operating Agreement" annexed to the Plan and petition.

(i) Diversion of the mortgaged estate and waste

As aforesaid, the $1,290,296.84 in the equipment retirement and depreciation accounts is the product of the mortgaged equipment and constitutes additional security therefor. The Plan does not utilize said moneys for the liquidation of the mortgage bonds nor of prior liens. Instead the Plan takes $1,121,000 from the $5,000,000 produced by the purchase money lien upon the Springfield Division to pay $846,000 to a prior lienor and to pay to Securities Corporation of the New York Central, $275,000 more than the *pro rata* on its bonds held in pledge.

It would appear that on default day, April 1, 1940, the $5,000,000 purchase money lien and the $1,290,296.84 equipment fund were available exclusively for the First Consolidated Mortgage Bondholders, a total of $6,290,296.84, instead of the $3,879,000 distributed to them under the Plan —an apparent diversion from the mortgage estate of $2,410,000, equivalent to $270 per outstanding bond. After such diversion, the cash payments to the bondholders under the Plan are $450 per $1,000 bond.

In addition, the 6% interest on the equipment retirement and depreciation fund, attempted to be offset against the advances of New York Central, should have been avail-

able to the mortgage trustee upon any proper accounting; or in the alternative the loss of $1,316,077 resulting from failure to properly maintain the rolling stock should have been available.

The court below declined to refer the case to a special master or to pass upon the so-called inter-company accounts, leaving undetermined for some future proceedings the questions involved in such accounts (Decree, sec. 24; opinion, appendix A, pp. 29-30), although the validity and enforcibility thereof would seem to lie at the threshold of the proceeding; involving the two-fold questions as to what was available for the payment of the matured bonds, and whether there had been such diversion or such use by the parent company of Peoria & Eastern as to make it inequitable to continue the operating agreement in its favor.

(j) Approval of Plan

The District Court confirmed the Plan except that it permitted the income bondholders to have one representative on the Board, but declined a similar request by the First Mortgage Bondholders, and "reserved for future determination" the inter-company accounts (Decree, Secs. 24, 25).

The plan had been approved by the Interstate Commerce Commission and by over 75% of the Mortgage Bondholders. By the Railroad Adjustments Act, the Court must "scrutinize the facts independently of the extent of acceptances" and of the "findings" of said Commission (§ 725 [3]).

The Assignments of Error

The District Court erred in decreeing that the Plan should be approved; specifying:

(a) The Peoria & Eastern had insufficient assets and earnings to support its capital structure, hence its fi-

nancial difficulties are not "temporary only", but fundamental. This requires, not a short term arrangement under Chapter XV, but a "financial reorganization of the character provided for under" Section 77 of the Bankruptcy Act (Railroad Adjustments Act, § 710 (2) (a), (b)).

(b) Such deficiency of capital and earnings required the elimination or complete subordination of junior debts and stockholders—particularly of New York Central as parent and operating corporation—so as to free future earnings for the payment not only of interest but also of amortization or sinking fund upon the overdue first mortgage debt. Fear lest rejection of the Plan might bring worse results, inducing high percentage of bondholders' consents (Opinion, pp. 33-35), should not coerce the Court to declare as "fair and equitable" what has been denounced uniformly as inequitable (*Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106, 112-113, 122-124).

(c) There is no finding of "inability to meet its debts matured or about to mature" and no finding of any efforts to obtain funds in the capital markets or from Reconstruction Finance Corporation or from New York Central in reparation of asserted diversion and waste of assets [§ 710 (2) (b)].

(d) The Plan forces an extension of twenty years upon bonded debt, due to insufficient assets and earnings. This does not satisfy the requirement that "inability to *meet* its debts" will be "temporary" only. Debts are not met with only temporary delay by avoiding them completely for twenty years, or maybe indefinitely if railroad revenues and values continue their downward trend. A twenty year moratorium is not, in fact or in law, the equivalent of reasonably prompt payment. (§ 710 (2) (b); In the matter of Flour Mills of America, S. E. C. release No. 22, April 11, 1940).

(e) The Plan is not "fair and equitable as an adjustment" and does not "conform to the law of the land regarding the participation of the various classes of creditors and stockholders [§ 725 (c)]. The Plan

provides for payment of principal and interest upon the advances of New York Central (the parent and operating corporation) and preserves its stock and management control with their incidental advantages and emoluments—all, without paying or making provision for the payment or amortization of the matured mortgage debt which, by its terms has priority. (*Louisville Trust Co.* v. *Louisville, N. A. & C. Ry. Co.,* 174 U. S. 674 (Monon case); "the *Boyd* case, its antecedents and its successors", including *Case* v. *Los Angeles Lumber Co.,* 308 U. S. at 118, 120).

(f) The Plan should not have been approved and no equitable relief against strict foreclosure should have been granted where charges of diversion of assets and earnings are made against the parent corporation and not determined by the Court but left open for future determination. Thereby, the parent corporation gets full protection for its dominating position and its investment, without any determination of whether it is barred from such equitable relief by its own inequity (*Monon* case, *supra; Farmers Loan & Trust Co.* v. *N. Y. & Northern,* 150 N. Y. 410).

(g) The Plan should not have been approved because it recognized New York Central as a creditor in competition with prior lienor, whereas Peoria & Eastern was its mere instrumentality whose affairs it dominated and whose assets and accounts it confused with its own; so that its advances should have been treated as capital contributions.

(h) The mortgagee bondholders are entitled to their money or the property. If junior interests are to be saved from strict foreclosure, the mortgagee bondholders must be secured in their lien upon the property and its earnings for the repayment of their debt with interest. A sinking fund payable out of earnings should be established at least up to the present estimated amount of such earnings; leaving for the junior interests any additional earnings which their industry, fidelity and ability may create. The estimated net earnings presently available based upon 1939 gross revenue are $304,727 with increases expected for 1940

(Finding 24). $306,950 for the first year should be allocated to the mortgage bondholders, of which $188,892 should go for fixed interest at 4% for the first year and lesser amounts as bonds are retired through the sinking fund. This would require a sinking fund of 2½%, cumulative, payable, if earned, which would absorb $118,058 of such earnings in priority to the $108,897.37 which the New York Central absorbs under the Plan (*ante,* page 10). If earnings continue, this would retire half of the bonds at maturity, or a much larger percentage so long as the modified bonds continue at low levels. (Present market price about 46.) In this manner, the average maturity of the extension is reduced by at least a quarter, and the lien of the mortgage bondholder is recognized for the payment not only of interest but also for the repayment of the overdue principal. To safeguard the proper application of earnings, the mortgage bondholders should be entitled to a representative upon the Board. The Plan should not have been approved without incorporating these provisions as a modification under § 725 (2).

(i) The prior lien of the mortgage bondholders upon the equipment should also have been recognized by modification which would require the utilization of the $768,710.44 in the equipment depreciation account as an additional sinking fund to reduce the bonded debt. This, too, would reduce the average maturity of the extension and reduce fixed interest; and, at prevailing low quotations, would enormously benefit not only the mortgage bondholders, but also the junior creditors by so large a reduction of the bonded debt. The Plan should not have been approved without incorporating this provision as a modification under § 725 (2).

(j) The Plan should not have been approved without a prior accounting by the Big Four and the New York Central as to the charges of diversion and waste of assets appearing *prima facie* of record.

The foregoing subdivisions lettered (a) to (j), are intended to be assigned as errors individually and also in combination with other subdivisions.

Reasons for Allowance of the Writ

1. The decree herein is in conflict with the applicable decisions of this Court, in that it secures for the equity owner priority of payment of interest and principal upon its advances without providing for payment of the overdue mortgage debt which has seniority; particularly where, as here, there are not enough assets and earnings to support the capital structure established by the Plan. (*Case* v. *Los Angeles Lumber Co.*, 308 U. S. 106; *Securities and Exchange Commission* v. *U. S. Realty Improvement Co.*, 84 L. Ed. 966.)

2. The decree herein is in conflict with the applicable decisions of this Court, in that it secures for the equity owner full recognition for its dominating position and investment and full equitable relief against strict foreclosure where charges of inequitable conduct through diversion of assets and earnings are based upon record facts but left undetermined. (*Louisville Trust Co.* v. *Louisville, N. A. & C. Ry. Co.*, 174 U. S. 674.)

3. The decree herein decides an important question of Federal law, which has not been, but should be, settled by this Court; namely, whether the Railroad Adjustments Act contemplates anything more than a reasonable moratorium to meet a temporary emergency, leaving long term adjustments and basic changes required by deficits in assets or earnings to the more careful scrutiny and determination pursuant to Section 77 of the Bankruptcy Act.

4. The decree herein is in conflict with applicable decisions in this Court, in that it permits a parent corporation which is within the "Instrumentality Rule" to compete as to its advances with outside creditors without subordinating its claim; where, as here, there has been com-

plete domination of the subsidiary and a confusion of its assets, transactions and accounts. *Taylor* v. *Standard Gas & Electric Co.*, 306 U. S. 307; *Pepper* v. *Litton*, 84 L. Ed. 160.

5. The District Court has departed from the usual course of judicial proceedings in reorganization cases, in that it assumed there was no alternative between approving the Plan and ordering a strict foreclosure; whereas, the accepted practice is for the court to suggest modifications of the Plan in the interest of fairness and legality; which modifications, in line with subdivisions (h) and (i) aforesaid, should provide for the application of the equipment depreciation account of $768,710 and the annual application of $118,058 of estimated surplus earnings for sinking fund purposes. This would recognize the mortgage bondholders' lien upon the property and its earnings, would reduce the average maturity of the extension from twenty years to less than ten years, and would increasingly benefit junior creditors through the annual decline of prior liens and prior interest charges.

6. Not to allow this appeal would depart from the usual course of judicial proceedings, since there was no Special Master whose findings might have been reviewed by the Special Court, and, therefore, matters of such weight and importance would rest upon the single decision of the trial court, without any opportunity for a considered review of their decision.

WHEREFORE, YOUR PETITIONERS PRAY for the allowance of a writ of certiorari to the District Court of the United States for the Southern District of New York in this cause, there entitled "In the Matter of The Peoria and Eastern Railway Company, Petitioner", that said cause may be reviewed and determined by this Court and that

the decree of said District Court may be reversed and set aside; and for such further relief and remedy as this Court may deem meet and proper.

Dated: New York, N. Y.,
September 26, 1940.

DONALD N. GILBERT, HAROLD C. YEAGER
and GEORGE A. CAREY, Petitioners,

By SCRIBNER & MILLER,
ALFRED E. SMITH, JR.,
Solicitors of Petitioners.

MARK HYMAN,
Counsel for Petitioners.

Appendix A

DISTRICT COURT OF THE UNITED STATES

FOR THE SOUTHERN DISTRICT OF NEW YORK

WILLIAM CARNEGIE EWEN, and others,
Intervenors,

against

THE PEORIA & EASTERN RAILWAY COMPANY,
Petitioner.

DONALD N. GILBERT, and others,
Intervenors,

against

THE PEORIA & EASTERN RAILWAY COMPANY,
Petitioner.

Before: L. HAND, Circuit Judge,
WOOLSEY and HULBERT, District Judges.

This cause comes on upon a hearing under § 720 of the Bankruptcy Act, of a petition filed by the Peoria & Eastern Railway, for confirmation of a "plan of adjustment" filed under § 710. Two committees of security holders have intervened under § 720: that of Ewen and others, representing the "income bondholders"; and that of Gilbert and others, representing a minority of the first consolidated mortgage bondholders. Both object to confirmation, though not for the same reasons. The evidence was taken before a court constituted under § 713; and the case was later argued and submitted upon briefs.

Appendix A

JACOB ARONSON and CROSBY J. BEAKES, for the petitioner;

CHARLES S. ARONSTAM and ARCHIE S. KARP, for the income bondholders;

LOUIS G. BERNSTEIN, JULIUS J. ROSENBERG, LEONARD B. FRUTKIN and WILLIAM J. REINHART, JR., for the first mortgage bondholders.

L. HAND, C. J.: The facts are sufficiently stated in the report of the Interstate Commerce Commission, (March 27, 1940), passing upon the plan, and we shall accept it as the background for our discussion. The objections are chiefly because the plan disregards rights originally secured to the intervenors in the reorganization of the Ohio, Indiana & Western Railroad, a mortgage upon which was foreclosed in 1889. On the sale under the decree in that suit Coster and Spencer, who were acting for a committee of the old bondholders, bought in the property and effected a reorganization by a series of documents all dated February 22, 1890, implementing an earlier agreement of October 30, 1889. The general outline of the reorganization was that the Ohio, Indiana & Western Railway, which had been operating a road from Peoria, Illinois, to Springfield, Ohio, should be divided into two parts, at the City of Indianapolis. The "Big Four" railroad—now controlled by the New York Central—bought in the eastern part in fee—which we shall call the Springfield Division—paying for it by giving to Coster and Spencer a lien upon it of $5,000,000, due on April 1, 1940, the principal of which it did not bind itself to pay, though it guaranteed the interest at four per cent. The western part of the road—which we shall call the Illinois-Indiana Division—Coster and Spencer conveyed to a new corporation, the Peoria & Eastern, the petitioner

here. That is to say, they conveyed the fee of that part which was in Illinois, and they leased in perpetuity that part which was in Indiana, conveying the reversion later. (Why this curious device as to the Indiana part was adopted, does not appear). The petitioner paid for the Illinois-Indiana Division in bonds and shares of the new road, delivered to Coster and Spencer and by them presumably distributed among the old bondholders of the Ohio, Indiana & Western Railway. The "Big Four" bought half the shares and made an operating agreement with the new road by which it was granted the privilege of operating the Illinois-Indiana Division for fifty years, in consideration of which it was to pay all operating expenses, and the interest on the mortgages just issued to Coster & Spencer, as well as that on two mortgages already on the property, one for $500,000 which covered both divisions, and the other for $1,000,000 which covered only the Illinois-Indiana Division. The plan proposes to extend this agreement for twenty years beyond April 1, 1940, and the first question is whether the New York Central has the right to do so against the opposition of the intervenors.

1) The Extension of the Operating Agreement.

The first article of the operating agreement, so far as pertinent, read as follows: "the Cleveland Co. shall and will henceforth and during the period of fifty years from April 1st, 1890, and for such further time thereafter as it may elect, use and operate" the Illinois-Indiana Division. It is possible to construe these words, either as giving the "Big Four" a license to remain in possession for as long as it chose after the expiration of fifty years, or as giving it an option, to be exercised before the expiration of the term, to extend it for another fixed period. The first would result

in a mere tenancy at will, terminable by either party, or from year to year, and the income bondholders might in that case be prejudiced by the proposed extension for a fixed term. Substantially similar words were construed in Western Transportation Co. v. Lansing, 49 N. Y. 499, as creating a tenancy at will, or from year to year, and the decision is the intervenors' main reliance. It is to be noted, however, that the court very particularly (p. 508) refused to pass upon whether, if the clause had created an option giving the lessee a privilege pending the term to extend it for a new, though indefinite, period, it would have been invalid; and the decision is therefore at most only an interpretation of the particular lease then before the court. It would not in any case be authoritative upon us, for the property at bar is in the States of Illinois and Indiana, where we have been unable to find any pertinent decisions; but it may be that in the case of an ordinary agricultural lease between individuals, like that there at bar, it is proper to interpret such a privilege as no more than a tenancy at will, or from year to year. On the other hand it seems to us quite inappropriate to adopt the same construction for an operating agreement between two railroads. The relation created involves elaborate and complicated operating adjustments, and to give either road a power to denounce it at will, or even at a year's notice, would put both in a position which, if not intolerable, would at least be extremely instable and unsatisfactory. We therefore construe the clause as giving the "Big Four" an option pending the term to extend it for a specified period in the future. (Whether more than one such extension was contemplated we need not decide). The fact that the extension was left indefinite, and was to be fixed by the "Big Four", was immaterial; it has been law for over three hundred years that uncertainty in the length of a term at the time of the ex-

ecution of a contract to grant it, is no objection, if its duration will become certain before it begins. Say v. Smith, 1 Plowden 269. The new term was here certainly for a "reasonable" period, assuming that such a condition was to be implied.

2) Prejudice to the Income Bondholders by the Extension.

What we have just said disposes of the argument that the extension could operate to the prejudice of income bondholders. Their bonds were made expressly subject to the agreement, and, if we are right, that included the power to extend the term. It is true that by so doing the New York Central will be able to recoup for its past advances out of future income, a privilege which would have otherwise ended on April 1st, 1940; but if that was what the agreement intended, no wrong will be done. The suggestion that the original transaction is now subject to be reopened because the "Big Four" had bought half the Peoria & Eastern Railway's shares is without merit. In the first place, while the agreement was with the Peoria & Eastern, the transactions were in fact with Coster and Spencer, that is, with the old bondholders of the Ohio, Indiana and Western Railway, who presumably dealt with the "Big Four" at arms' length, who, as shareholders, were charged with knowledge of the whole transaction, and who were free to accept any conditions upon the income bonds that they chose. And that aside, we cannot understand how it can be seriously argued that after the lapse of fifty years, the contract should be unravelled, even if there had been substance in the objection at the outset.

3) The payments Due under the Operating Agreement.

The third article of the agreement provided that the "Big Four" should receive all the income of the Peoria & Eastern Railway, deduct "the expenses of operation and maintenance", taxes and the like, and, out of the "net" income so resulting and any income from the $5,000,000 lien upon the Springfield Division, should pay all interest falling due upon the two prior mortgages and the first consolidated mortgage. If anything were then left, the "Big Four" was to reimburse itself "for any advances hereunder in any previous year remaining unpaid to it (with interest thereon at the rate of six per cent, per annum)", and finally to pay any balance, first to the income bondholders, and after them to the shareholders. This language is unequivocal; it appropriated each year's surplus, to all accumulated advances; the income bonds were to receive nothing until these were all paid. The second article of the agreement contains language which, however, both intervenors insist modified the meaning of the third, and fixed a minimum rental of $412,200, which the "Big Four" was bound to pay, regardless of any reduction in the interest due upon the three mortgages. The passage relied upon was in substance that the "Big Four" agreed that it would "make good any deficiency which may at any time occur in the fund necessary" to pay the interest, "after devoting to such payment" the "net income" from the purchase-money lien on the Springfield Division, and "net earnings" of the two parts of the Illinois-Indiana Division. It guaranteed—and it is this language which is supposed to create a minimum rental —"that the net earnings and income from said three sources, so actually applied to the payment of said interest, shall not be less than four hundred and twelve thousand two hundred dollars" annually for the whole period of fifty years. (The guaranty included in addition forty dollars

for each bond, issued by the Peoria & Eastern above the amount provided at the time, $9,430,000.) It appears to us clear that this was intended only as a guaranty that the income of the road should pay interest on all the bonds outstanding, just as the guaranty of the purchase money lien did that the income of the Springfield Division should pay interest on the lien itself. The text alone demands that conclusion, for the guaranty does not cover generally the net earnings and the income of the road, but only those earnings and that income, when "actually applied to the payment of interest". One cannot apply money in payment of interest upon a cancelled bond. (It is perhaps worth while also to note that the covenant runs not only to the Peoria & Eastern, but to the bondholders as well.) It is true that the "Big Four" got the advantage of operation of the division for no more than a guaranty of its fixed charges; and possibly the bargain was indirectly worth more than that to it, though the actual operation appears to have been at a loss. Be that as it may, if more than a guaranty of the fixed charges had been intended, the parties would surely not have fixed a rental—for in that event there would have been a rental—at such sum as $412,200. That was an absurd sum, unless they were thinking in terms of the fixed charges. Furthermore, if it was a rental, the supposed lessee would normally not have had a charge for any deficit in operation. Both articles seem to us therefore to be harmonious, and to provide that the income bondholders should get nothing except any surplus over all current charges, past and present.

4) The Accounts between the New York Central and the Peoria & Eastern.

Not only has a large operating deficit accumulated against the Peoria & Eastern, but a large "retirement" account and

a large "depreciation" account have accumulated in its favor against the New York Central. The plan does not liquidate either of these, and the order of confirmation will leave open all questions touching their amount and validity. If the New York Central seeks in any year to withdraw any part of the earnings by way of recoupment, it must prove its right. All we now hold is that the covenant to maintain the road and to make additions to its equipment, did not contemplate gratuitous advances, and that the third article allowed recoupment for so much as was properly expended. Whether the cross items can be offset, the plan also leaves open.

5) The Use of $500,000 First Consolidated Mortgage Bonds as Security for the Peoria & Eastern's note.

The proceeds of a note of the Peoria & Eastern in favor of a subsidiary of the New York Central, were used to take up the $500,000 of prior bonds that were a lien upon both divisions of the road. The security for this note was $500,000 of the first consolidated bonds and 1730 shares of the Peoria & Pekin Union. The first question is whether the bonds were lawfully pledged under the mortgage, and that depends upon the seventh article. Fifteen hundred thousand dollars of the issue of ten millions was reserved to be issued "as may be necessary for the purposes of exchange for said prior bonds as hereinafter provided"; i. e., "when * * * the Railway Company shall deliver * * * to said Central Trust Company * * * any of said prior bonds * * * Central Trust Company shall issue to the Railway Company * * * an amount of said bonds so reserved equal at par to the amount of the said prior bonds so delivered at par". The argument is that the pledge was not such an exchange, and was therefore invalid. Even so, the lender would be entitled to be subrogated to the old bonds, paid by the bor-

rowed proceeds. Subrogation is a purely equitable doctrine (Restatement of Restitution, § 162); it disregards form, and here, the transaction would have been entirely regular if the following form had been adopted. The lender could have bought the old bonds, holding them without turning them in for cancellation. It could then have surrendered them to the Peoria & Eastern, which could in turn have surrendered them to the trustee of the mortgage in exchange for new bonds, par for par. The Peoria & Eastern could at the same time have delivered the shares of the Peoria & Pekin Union as additional security for any difference in value between the old and the new bonds, for the first consolidated bondholders could not have complained if the road had used its free assets to carry through such a transaction. Since all this would have been entirely lawful, and would not have impaired any rights of the bondholders, equity will effect the same result, even though the form chosen—i. e., a direct pledge of the bonds—was invalid.

The plan properly assumes, therefore, that the pledge was good; and deals with the note by treating $210,000 of the bonds as issued, and paying the remaining $290,000 at par out of the $5,000,000 by which the New York Central will cancel the lien on the Springfield Division. The lender must then release, not only the pledged bonds, but the 1730 shares of the Pekin & Peoria Union. The intervenor suggests that the bonds are now worth 60; if so, although no more than $174,000 should be allotted to the cancellation of the $290,000 of new bonds, the Peoria & Pekin Union shares will account for the balance, $116,000. It is true that the evidence of their value might be better, but it is reasonably apparent that there is nothing unfair in this part of the adjustment.

6) Contribution by the Springfield Division to the Illinois-Indiana Division.

The question as to this is whether the $500,000 prior mortgage upon both divisions should be wholly assumed by the Illinois-Indiana Division, or whether the Springfield Division should contribute ratably to its discharge. The deed of Coster and Spencer to the "Big Four", conveying the Springfield Division, was indeed without warranty, but the question whether a mortgagor who conveys part of the property means to make a lien a primary incumbrance on what he retains, cannot be answered merely by recourse to the conveyances, or the order of their execution; it must be gathered from the implications of the particular transaction. The operating agreement required the net income from the purchase-money lien on the Springfield Division to be used to pay interest upon all three mortgages, the $500,000 mortgage among them, and therefore as to interest the Springfield Division was certainly not to contribute. The same intent appeared also as to the principal, because, although the first consolidated mortgage did not cover the Springfield Division at all, it provided that new bonds might be exchanged for the bonds of the $500,000 mortgage. Moreover, by the fifth article the Peoria & Eastern promised to "pay at the maturity thereof all principal of such of said prior bonds as shall not have been previously taken up by exchange". Since all the papers were parts of a single transaction and are to be read together, the mortgage was intended to be a burden on the Peoria & Eastern. The intervening first consolidated bondholders deny this; they explain the covenant as merely making it a default under the consolidated mortgage for the Peoria & Eastern not to pay the prior mortgages at their maturity. But if that was the only purpose, it did not require an assumption of the mortgages by the Peoria & Eastern; all that was necessary

was to declare that default upon the prior mortgages should be a default upon theirs. Moreover, after any of the old bonds were exchanged for new the lien on the Springfield Division was on any theory pro tanto extinguished. Why should contribution exist only as to those that might not be exchanged? We can see no reason therefore for so circumscribing the significance of the covenant. In any event all these circumstances taken together satisfy us that the lien of the $500,000 prior mortgage was to be upon the Illinois-Indiana Division alone.

7) The Unfairness of the Plan to the First Consolidated Bondholders.

The first consolidated bondholders argue that the extension of the operating agreement is "unfair" within the doctrine of Case v. Los Angeles Lumber Products Co., 308 U. S. 106, because it allows the New York Central to recoup out of the income of the Peoria & Eastern properly applicable to the bonds, although the accumulated advances are a junior claim. This, as we have seen, is not a valid position in the mouth of the income bondholders because they took subject to an extension of the operating agreement; but that is not true as to the first consolidated bondholders, and the answer must depend upon other considerations. Under the plan the New York Central guarantees interest for twenty years on the remaining principal of the bonds, and their maturity is extended accordingly. Since this will take only $188,000, and the present estimated income of the road is about $304,000, at first blush the plan appears to create an unlawful priority in favor of junior claims. However, the situation is not so simple. If the plan fails of confirmation, the bondholders will, it is true, be able to foreclose upon the Illinois-Indiana Division immediately, but if they take it in, the debt against it will not be only

the whole of the present first consolidated mortgage, but what is left of the prior lien bonds together with the note secured by the pledge. The New York Central probably will, and lawfully may, withdraw its deposit of $5,000,000, because the "Big Four" never undertook to pay the lien. That well may result in the foreclosure of the lien, and that in turn will subject the Springfield Division to the first consolidated mortgage since it covers the lien. But it is impossible now to say what in that event will be the net income of the two divisions, and how it will compare with the fixed charges. No present figures could throw any light upon that question, because the result would be a dismerberment of the system; for the New York Central could route its freight by other rails, and might do so, if the bondholders, being in possession of both divisions, would not come to terms. It is therefore not true to say that there is any assured income applicable to the first consolidated bonds upon foreclosure, which is to be used to pay junior debts. Acceptance of the plan was a question of judgment, which a majority of three-fifths might decide, § 725 (2). In fact nearly four-fifths have decided for the plan, and the minority must accede.

9) Fulfillment of the Conditions Prescribed by § 725 of the Bankruptcy Act.

It is clear that the situation is not proper for the radical reorganization provided by § 77; nobody suggests, for example, that the Peoria & Eastern should be put into the hands of trustees, which that section would require. The road is temporarily embarrassed, but no more. On the other hand, if the plan goes through, there is ground for expectation that the road will be able to meet its debts; its chief difficulty has been the maturity of the first consolidated mortgage. If that can be refinanced as here provided,

there is good prospect that the road can go on, and not only serve the public, but meet its debts, as they fall due. It is not likely to become insolvent, for its earnings are more than enough to meet its fixed charges; and, so far as we can see, no future financing will be necessary which will be beyond its powers. We recognize, of course, that these conclusions are conjectural, but that is inevitable. The important fact is that the plan fends off what might very well result in the disruption of an important part of a large transportation system, and does so with proper regard for the rights of all. We have tried to exercise that independent judgment which § 725 (3) requires of us, but it is impossible not to be influenced—e. g., as to the practicability of success—by the findings of the Commission. We do not understand, however, that in this we have been delinquent; quite the contrary, we ought to give great weight to its conclusions upon matters within its expert competence, even though in the end we are indeed charged with final responsibility for the result.

The last paragraph of § 725 also requires us to approve the continuation of the existing voting rights in the Peoria & Eastern and in the way in which its directors and officers are selected. We must find that continuation "adequate, equitable, in the best interests of creditors and stockholders, and consistent with public policy". This we understand gives us a free hand in requiring the plan to give such representation as is equitable to the creditors. The income bondholders occupy much the same position as preferred shareholders, and as such they have a very lively interest in the payment of the accumulated advances. We think that they should have representation upon the road's board of directors, so that they may continually keep advised of its affairs without the mediation of a court. We cannot, however, see any advantage in giving them more than one director, and certainly it would be extremely prejudicial to

give them a majority, which is what they ask in case no income is paid on the bonds for two years. That might make joint operation difficult or impossible, and failure to pay interest on these bonds is not a default at all. All they need is some one who will have the absolute right to scrutinize the road's operation, management and finances. Hence we will modify the plan by virtue of the power given us in § 721 so as to provide that the income bondholders shall have one director upon the board. This does not require resubmission to the Commission under § 721 (a); nor does it substantially affect the interests of any class of creditors so as to require resubmission to any of these under § 721 (b). The plan will therefore be modified to that extent and approved as modified.

The expenses of this proceeding are so moderate as to require no discussion.

The petitioner will submit proposed findings and conclusions and a proposed decree within five days after the filing of this opinion. The intervenors will file any supplements or amendments to these within five days thereafter.

Appendix B

Pertinent provisions of Chapter 15 of the Bankruptcy Act (July 1, 1898, c. 541, §§ 700-755, as added July 28, 1939, c. 393, 53 Stat. 1141, 11 U. S. C. A. 1200-1255) are as follows:

11 U. S. C. A., § 1206 (§ 706)—Creditors affected by plan

No creditor shall be deemed to be "affected" by any plan unless such plan proposes a modification of the evidence of debt or other instrument defining the rights of such creditor, or a modification of the security, if any, for the claim of such creditor.

* * * * * *

11 U. S. C. A., § 1210 (§ 710)—Filing petition; requisites; place; contents

Any railroad corporation not in equity receivership or in process of reorganization under section 205 of this title at the time of filing its petition hereunder, and which has not been in equity receivership or in process of reorganization under said section 205 within ten years prior to the filing of such petition, which shall have—

(1) Prepared a plan of adjustment and secured assurances satisfactory to the Commission of the acceptance of such plan from creditors holding at least 25 per centum of the aggregate amount of all claims affected by said plan of adjustment (including all such affected claims against said corporation, its parents and subsidiaries), and

(2) Thereafter obtained an order of the Commission, (but not of a division thereof), under section 20a of Title 49 authorizing the issuance or modification of securities as proposed by such plan of adjustment (other than securities held by, or to be issued to Reconstruction Finance Corporation), such order of the Commission to include also specific findings:

(a) That such corporation is not in need of financial reorganization of the character provided for under section 205 of this title;

(b) That such corporation's inability to meet its debts matured or about to mature is reasonably expected to be temporary only; and

(c) That such plan of adjustment (after due consideration of the probable prospective earnings of the property in the light of its earnings experience and of such changes as may reasonably be expected,—

(i) is in the public interest and in the best interests of each class of creditors and stockholders;

(ii) is feasible, financially advisable, and not likely to be followed by the insolvency of said corporation, or by need of financial reorganization or adjustment;

(iii) does not provide for fixed charges (of whatsoever nature including fixed charges on debt, amortization of discount on debt, and rent for leased roads) in an amount in excess of what will be adequately covered by the probable earnings available for the payment thereof;

(iv) leaves adequate means for such future financing as may be requisite;

(v) is consistent with adequate maintenance of the property; and

(vi) is consistent with the proper performance by such railroad corporation of service to the public as a common carrier, will not impair its ability to perform such service: *Provided,* That in making the foregoing specific findings the Commission shall scrutinize the facts independently of the extent of acceptances of such plan and of any lack of opposition thereto: *Provided further,* That an order of the Commission (or of a division thereof) under section 20a of Title 49, made prior to April 1, 1939, authorizing the issuance or modification of securities as proposed by a plan of adjustment (other than securities held by, or to be issued to, Reconstruction Finance Corporation), shall be effective for the purpose of this subparagraph (2) of the first sentence

of section 1210, notwithstanding failure to include therein the foregoing specific findings, if such order did include the specific findings that such proposed issuance or modification of securities is compatible with the public interest, is consistent with the proper performance by the railroad corporation of service to the public as a common carrier, and will not impair its ability to perform such service, and

(3) Secured assents to such plan of adjustment by creditors holding more than two-thirds of the aggregate amount of the claims affected by said plan, which two-thirds shall include at least a majority of the aggregate amount of the claims of each affected class,

may file in the United States district court in whose territorial jurisdiction such railroad corporation has had its principal executive or principal operating office during the preceding six months or a greater period thereof, its petition averring that it is unable to meet its debts, matured or about to mature, and desires to carry out the plan of adjustment.

A copy of the order obtained from the Commission, as above provided, shall be filed with the petition and made a part thereof.

* * * * * *

11 U. S. C. A., § 1213 (§ 713)—Convention of three-judge court to act on proceedings

Immediately following the filing of the petition, there shall be convened a special court of three judges in the manner provided by section 380, as amended, of Title 28, and thereafter all proceedings relative to such plan or any modification thereof shall be conducted before such court. Such three-judge court shall be vested with and shall exercise all the powers of a district court sitting in equity and all the powers as a court of bankruptcy necessary to carry out the intent and provisions of this chapter, including the classification of claims at such time and in such manner as the court may direct.

Appendix B

11 U. S. C. A., § 1221 (§ 721)—Approval, or modification and approval, of plan after hearing

After such hearing, the special court may approve the plan as filed or propose to modify such plan and as hereinafter provided approve the same as so modified. If the court shall propose to modify the plan, then: (a) if such modification substantially alters the basis for the specific findings included in the order made by the Commission under section 20a of Title 49, the plan as so proposed to be modified shall be resubmitted to the Commission and shall not be finally approved by the court until the Commission (but not a division thereof) has authorized the issuance or modification of securities as proposed by the plan as so modified (other than securities held by, or to be issued to, Reconstruction Finance Corporation) making the findings required by clause (c) of subparagraph (2) of the first sentence of section 1210, even in a case where the original order of the Commission under said section 20a was made prior to April 1, 1939; and (b) if such modification substantially or adversely affects the interests of any class or classes of creditors, such plan shall be resubmitted, in such manner as the court may direct, to those creditors so affected by such modification and shall not be finally approved until after (1) a hearing on such modification, to be held within such reasonable time as the court may fix, at which hearing any person in interest may object to such modification, and (2) a reasonable opportunity (within a period to be fixed by the court), following such hearing, within which such affected creditors who have assented to the plan may withdraw or cancel their assents to the plan, and failure by any such creditor to withdraw or cancel an assent within such period shall constitute an acceptance by such assenting creditor of the plan as so modified. After such authorization and finding by the Commission, where required hereby, and after such hearing and opportunity to withdraw or cancel, where required hereby, the court may make the proposed modification, and as provided in section 1225 finally approve and confirm the plan as so modified.

* * * * * *

Appendix B

11 U. S. C. A., § 1225 (§ 725)—Approval and confirmation of plan; requisites

If the special court shall find—

(1) That, at the time of the filing of said petition as provided in Subchapter III hereof, the proposed plan of adjustment had been assented to by not less than two-thirds of the aggregate amount of all claims of the petitioner affected by such plan, including at least a majority of the aggregate amount of claims of each such class;

(2) That the plan of adjustment as submitted or as modified by the court has been accepted as submitted or, if modified, then as modified by or on behalf of creditors affected by such plan holding more than three-fourths of the aggregate amount of the claims affected by said plan, including at least three-fifths of the aggregate amount of the claims of each affected class;

(3) That the plan meets the requirements of clause (c), and the petitioner meets the requirements of clauses (a) and (b) of sub-paragraph (2) of the first sentence of section 1210, and that the plan is fair and equitable as an adjustment, affords due recognition to the rights of each class of creditors and stockholders and fair consideration to each class thereof adversely affected, and will conform to the law of the land regarding the participation of the various classes of creditors and stockholders: *Provided*, That in making the findings required by this clause (3), the court shall scrutinize the facts independently of the extent of acceptances of such plan, and of any lack of opposition thereto, and of the fact that the Commission, under section 20a of Title 49, has authorized the issuance or modification of securities as proposed by such plan, and of the fact that the Commission has made such or similar findings;

(4) That all corporate action required to authorize the issuance or modification of securities pursuant to such plan shall have been duly taken;

(5) That the petitioner has not, in connection with said plan or the effectuation thereof, done any act or failed to perform any duty which act or failure would be a bar to the discharge of a bankrupt, and that the plan and the acceptance thereof are in good faith and have not been made or procured by any means, promises, or acts forbidden by this title; and

(6) That, after hearings for the purpose, all amounts or considerations, directly or indirectly paid or to be paid by or for the petitioner for expenses, fees, reimbursement or compensation of any character whatsoever incurred in connection with the proceeding and plan, or preliminary thereto or in aid thereof, together with all the facts and circumstances relating to the incurring thereof, have been fully disclosed to the Court so far as such amounts or considerations can be ascertained at the time of such hearings, that all such amounts or consideration are fair and reasonable, and to the extent that any such amounts or considerations are not then ascertainable, the same are to be so disclosed to the Court when ascertained, and are to be subject to approval by the special court as fair and reasonable, and except with such approval no amounts or considerations covered by this clause (6) shall be paid.

Said court shall file an opinion setting forth its conclusions and the reasons therefor and shall enter a decree approving and confirming such plan and the adjustment provided thereby, which decree shall be binding upon the petitioner and upon all creditors and security holders of the petitioner; and thereafter the petitioner shall have full power and authority to and shall put into effect and carry out the plan and the orders of the special court relative thereto and issue the securities provided by the plan without further reference to or authority from the Commission or any other authority, State or Federal, except where required by any law relating to the Reconstruction Finance Corporation, and the rights of all creditors and security holders with respect to claims and securities affected by the plan shall be those provided by the plan as so approved and confirmed: *Provided, however,* That the title of any

owner, whether as trustee or otherwise, to rolling-stock equipment leased or conditionally sold to the petitioner, and any right of such owner to take possession of such property in compliance with the provisions of any such lease or conditional sale contract, shall not be affected by the provisions of this chapter.

No plan shall be approved under this chapter unless the special court finds that with respect to the continuation of, or any change in, the voting rights in the petitioner, control of the petitioner, and the identity of, and the power and manner of selection of the persons who are to be directors, officers, or voting trustees, if any, upon the consummation of the plan and their respective successors, the plan makes full disclosure, is adequate, equitable, in the best interests of creditors and stockholders of each class, and consistent with public policy.

* * * * * *

11 U. S. C. A., § 1255 (§ 755)—Date of termination

The jurisdiction conferred upon any court by this chapter shall not be exercised by such court after July 31, 1940, except in respect of any proceeding initiated by filing a petition under section 1210 hereof on or before July 31, 1940.

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1940

No.

DONALD N. GILBERT, HAROLD C. YEAGER and GEORGE A. CAREY, constituting the First Mortgage Bondholders' Protective Committee for The Peoria and Eastern Railway Company's First Consolidated Mortgage 4% Bonds due April 1, 1940,

Petitioners,

against

THE PEORIA AND EASTERN RAILWAY COMPANY and WILLIAM CARNEGIE EWEN, LEWIS L. CLARKE and MAURICE D. ADAMS, as the Peoria and Eastern Railway Company Income Bondholders' Protective Committee,

Respondents.

MOTION TO DISPENSE WITH PRINTING AND SERVICE OF PORTIONS OF RECORD AND FOR THE PRINTING OF A JOINT RECORD

Counsel for petitioners in this case filed herewith their petition for a writ of certiorari to the United States District Court for the Southern District of New York, accompanied by a certified copy of the record of the proceedings in said District Court. Contemporaneously therewith counsel for the Income Mortgage Bondholders Protective Committee also filed a petition for a writ of certiorari together with a similar motion.

1. The nature of this case and the questions presented have been set forth in the foregoing petition for a writ of certiorari.

2. The said petition for a writ of certiorari does not request consideration by this Court of all the questions passed upon by the District Court. Many of the facts contained in the testimony and exhibits pertinent to the issues raised by said petition are succinctly set forth in the District Court's findings. Many of the exhibits were introduced so that reference could be made to only parts thereof. Petitioners now seek to be relieved of printing those parts of the record of proceedings below which are not necessary to a consideration of the questions presented by the petition for a writ of certiorari herein or which are contained in the uncontested findings of the lower court.

3. It is respectfully submitted that it would serve no purposes to have printed portions of the record below which pertain only to issues raised in the District Court but not raised herein.

4. The District Court made fifty-three findings giving the detailed history and present status of Peoria. Petitioners contest none of these findings except Findings Nos. 43-48 inclusive and No. 52, which are the conclusions of the District Court and do not purport to be findings of fact. Therefore, petitioners deem it unnecessary to print such portions of the proceedings and exhibits below as are contained in the uncontested findings of the District Court.

5. An effort was made to stipulate with counsel for Peoria & Eastern Railway Co. as to what parts of the record should be printed for submission to this Court. Annexed hereto and made a part hereof as if fully set forth herein are the letter of August 30, 1940 to the respondent Peoria pertaining thereto, and the letter of September 3,

1940 in reply thereto, respectively marked Exhibits A and B. Thereafter several conversations were had and it became apparent that no stipulation for curtailment of the record could be agreed upon. Counsel for Peoria and Eastern claim that with the exception of minor deletions, it was necessary to print the entire record of the proceedings below upon the ground that the detailed provisions of Chapter 15 of the Bankruptcy Act make it necessary to print so much of the record as is relevant to the specific findings required by the Act. Petitioners claim that since the formal jurisdictional requirements are contained in those of the lower court's findings which are not contested by petitioners, it is unnecessary to print the testimony upon which these findings were based.

6. If the entire record of the proceedings below were to be printed, the record before this Court would comprise approximately 2,000 printed pages, including 376 pages of testimony and 80 exhibits, some of which are extremely voluminous. The major portion of such a record would be entirely irrelevant to this appeal and would not be referred to by the parties or the Court, and would result in an overburdensome printing bill for petitioners.

7. The following constitute what the petitioners in conjunction with the Income Mortgage Bondholders Protective Committee believe are the papers necessary to be included in the record:

(1) Petition of Peoria and Eastern Railway Company.

(2) The Plan of Adjustment contained in Exhibit 5, omitting therefrom all material following page 28, all of which latter material is contained in other exhibits hereinafter listed, except the agreement evidencing extension of the First Consolidated Mortgage Bonds, which is obviously unnecessary.

(3) Exhibit 20 (First Consolidated Mortgage).

(4) Exhibit 23 (Income Mortgage Indenture).

(5) Exhibit 26 (Operating Agreement).

(6) Exhibit 27 (Supplement to Operating Agreement).

(7) Exhibit 29 (ICC decision).

(8) Exhibit 30 (ICC decision).

(9) Exhibit 33 (Agreement evidencing Extension of Operating Agreement).

(10) Exhibit 33½ (Result of Operations—1930-1939).

(11) Exhibit 34 (Profit and Loss Statement—1930-1939).

(12) Exhibit 35 (General Balance Sheet—1930-1939).

(13) Exhibit 36 (Summary of Expenditures).

(14) Exhibit 37 (Constructed Balance Sheet after disposition of the proceeds from the Purchase Money Lien).

(15) Exhibit 40 (Valuation to December 31, 1939).

(16) Exhibit 41 (Estimated Income for Next Five Years).

(17) Exhibit 46 (Letter of Transmittal of $5,000,000).

(18) Exhibit 49 (Letter from Big Four to Peoria and Eastern of election to extend Operating Agreement).

(19) Exhibits D, E and F (Directors and Officers of Peoria and Eastern, N. Y. Central and Big Four).

(20) Exhibit I (Analysis of Debt due Big Four and New York Central by Peoria and Eastern).

(21) Exhibit O (the first page only of the minutes pertaining to the statement of the president of the Big Four with respect to the leasing of the Peoria properties).

(22) The first three pages of Exhibit S containing the agreement between Big Four and the reorganization committee of the O. I. & W. Ry. Co.

(23) Exhibit Y (Letter of W. C. Ewen).

(24) Exhibit GG (Letter of Harold C. Yeager to Central Hanover Bank dated March 22, 1940).

(25) Direct testimony of Joseph A. Keegan, General Freight Agent of N. Y. Central.

(26) Stipulation respecting value of Springfield Division.

(27) The opinion of the Court.

(28) The Court's findings of fact and conclusions of law.

(29) Decree of the Court.

The Income Mortgage Bondholders are contemporaneously submitting to this Court a petition for a writ of certiorari and a motion for leave to delete the record, and it is respectfully requested that the Court refer to both motions at the same time.

WHEREFORE, it is prayed that (a) the printing and service of any portions of the record on appeal, except those items hereinabove in paragraph 7 enumerated, be dispensed with, and (b) the First Consolidated Mortgage Bondholders and the Income Mortgage Bondholders be allowed to print only one record jointly.

Dated, New York, N. Y., September 26, 1940.

Respectfully submitted,

DONALD N. GILBERT, HAROLD C. YEAGER and GEORGE A. CAREY, Petitioners,
By SCRIBNER & MILLER,
ALFRED E. SMITH, JR.,
Solicitors of Petitioners.

MARK HYMAN,
Counsel for Petitioners.

Exhibit A

COPY

August 30, 1940.

re *Peoria and Eastern Railway*

Jacob Aronson, Esq.
Crosby J. Beakes, Esq.
466 Lexington Avenue
New York, N. Y.

Dear Sirs:

Preparations are being made by the First Consolidated Bondholders' Protective Committee and the Income Bondholders' Protective Committee of the Peoria and Eastern Railway Company to apply to the United States Supreme Court for writs of certiorari to the Special District Court to review the decree entered in the above entitled proceeding.

Although separate writs of certiorari will be presented, the Committees are collaborating on the preparation of one record for the sake of brevity and convenience. In conformity with the rules of the United States Supreme Court with respect to printing only such portions of the testimony and exhibits pertinent to the issues to be presented to the Court, we believe that the following should constitute the record on appeal:

1. Petition of Peoria and Eastern Railway Company.

2. The Plan of Adjustment contained in Exhibit 5, omitting therefrom all material following page 28.

3. Extracts from Exhibit 20 (First Mortgage Indenture) pertaining to the description of the property covered by the Indenture and pertaining to the exchange of First Consolidated bonds for prior lien bonds.

Exhibit A.

4. That portion of paragraph Sixth of Exhibit 23 (Income Mortgage Indenture) as is contained on page 14 of the Income Mortgage, and last paragraph on page 6.

5. Exhibit 26 (Operating Agreement).

6. Exhibit 27 (Supplement to Operating Agreement).

7. Exhibit 29 (ICC decision).

8. Exhibit 30 (ICC decision).

9. Exhibit 33 (Agreement evidencing Extension of Operating Agreement).

10. Exhibit 33½ (Result of Operations—1930-1939).

11. Exhibit 34 (Profit and Loss Statement—1930-1939).

12. Exhibit 35 (General Balance Sheet—1930-1939).

13. Exhibit 36 (Summary of Expenditures).

14. Exhibit 37 (Constructed Balance Sheet after disposition of the proceeds from the Purchase Money Lien).

15. Exhibit 40 (Valuation to December 31, 1939).

16. Exhibit 41 (Estimated Income for Next Five Years).

17. Exhibit 46 (Letter of Big Four to Central Hanover Bank).

18. Exhibit 49 (Letter from Big Four to Peoria and Eastern of election to extend Operating Agreement).

19. Exhibit I (Analysis of Debt due Big Four and New York Central by Peoria and Eastern).

20. Exhibit O (That portion of the minutes pertaining to the statement of the president of the Big Four with respect to the leasing of the Peoria properties).

Exhibit A.

21. That portion of Exhibit S containing the agreement between Big Four and the reorganization committee of the O. I. & W.

22. Exhibit FF (Letter to Central Hanover Bank re $500,000 O. I. & W. bonds).

23. Exhibit 50 (Letter to Central Hanover Bank enclosed with Exhibit FF).

24. Exhibit GG (Letter of Harold C. Yeager to Central Hanover Bank dated March 22, 1940.)

25. Stipulation respecting value of Springfield Division.

26. The opinion of the Court.

27. The Court's findings of fact and conclusions of law.

28. Decree of the Court.

We shall be pleased to confer with you at your earliest possible convenience regarding any suggestions which you may have with respect to such additions to this record as you may see fit, so that we may enter into a stipulation agreeing upon the contents of the record.

Very truly yours,

SCRIBNER & MILLER,
ALFRED E. SMITH, JR.,
Attorneys for First Mortgage Bondholders' Protective Committee.
By JULIUS J. ROSENBERG.

CHARLES S. ARONSTAM,
Attorney for Income Mortgage Bondholders' Committee.
By ARCHIE S. KARP.

By Hand.

Exhibit B.

NEW YORK CENTRAL SYSTEM

JACOB ARONSON
Vice President, Law

466 LEXINGTON AVENUE
NEW YORK

September 3, 1940.

Messrs. Scribner & Miller,
Alfred E. Smith, Jr.,
Attys. for First Mtge. Bondholders' Protective Committee,
20 Exchange Place, New York, N. Y.

Mr. Charles S. Aronstam,
Atty. for Income Mortgage Bondholders, Committee,
50 Broadway, New York, N. Y.

Dear Sirs:

This will acknowledge your communication dated August 30th with reference to the Peoria & Eastern Railway Company proceeding.

In view of the detailed provisions of Chapter XV of the Bankruptcy Act under which this proceeding was had, it seems to us necessary that there be printed so much of the record as is relevant to the specific findings required by the Act. This seems particularly necessary in such a proceeding as this, where the statute calls for detailed proofs and specific findings regardless of the extent of acceptances of the plan or of any lack of opposition thereto. This will require the printing of the petition with its schedules, the several court orders, the applications for intervention and orders in respect thereof, testimony of witnesses, the petitioner's exhibits, the opinion of the court, the findings and decree. Of course, it is not intended that there shall not be included such of the intervenors' exhibits as you may desire. It is recognized that some of the exhibits are, for purposes of printing, susceptible of abbreviation and we are prepared to cooperate with you in that regard.

Awaiting your further advice, we are

Very truly yours,

JACOB ARONSON.

d

Office - Supreme Court, U. S.
FILED
OCT 23 1940
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1940

No. 466.

DONALD N. GILBERT, HAROLD C. YEAGER and GEORGE A. CAREY, constituting the First Mortgage Bondholders' Protective Committee for The Peoria and Eastern Railway Company's First Consolidated Mortgage 4% Bonds due April 1, 1940,

Petitioners,

against

THE PEORIA AND EASTERN RAILWAY COMPANY and WILLIAM CARNEGIE EWEN, LEWIS L. CLARKE and MAURICE D. ADAMS, as the Peoria and Eastern Railway Company Income Bondholders' Protective Committee,

Respondents.

REPLY MEMORANDUM FOR PETITIONERS AND ANSWER TO REPLY OF RESPONDENT, THE PEORIA AND EASTERN RAILWAY COMPANY, TO PETITIONERS' MOTION FOR DIMINUTION OF RECORD.

DONALD N. GILBERT, HAROLD C. YEAGER and GEORGE A. CAREY, Petitioners,
By SCRIBNER & MILLER,
ALFRED E. SMITH, JR.,
Solicitors of Petitioners.

MARK HYMAN,
Counsel for Petitioners.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1940

No. 466.

DONALD N. GILBERT, HAROLD C. YEAGER, and GEORGE A. CAREY, constituting the First Mortgage Bondholders' Protective Committee for The Peoria and Eastern Railway Company's First Consolidated Mortgage 4% Bonds due April 1, 1940,

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THE PEORIA AND EASTERN RAILWAY COMPANY and WILLIAM CARNEGIE EWEN, LEWIS L. CLARKE and MAURICE D. ADAMS, as the Peoria and Eastern Railway Company Income Bondholders' Protective Committee,

Respondents.

REPLY MEMORANDUM FOR PETITIONERS

The questions presented, the assignments of error and the reasons for the allowance of the writ, divide into three main categories:

I

From the indicated minimum net operating revenue of $304,727, the first mortgage interest absorbs $188,892 and the junior creditor-stockholder absorbs on its claim the balance of $115,835 and all additional sums expected with

improved railroad earnings. The outstanding first mortgage bonds matured on April 1, 1940. If the company was unable to pay the same, it should at least appropriate thereto the expected net earnings of the property, and not force the bondholders to leave their capital in the business for twenty years while the parent corporation receives interest and principal upon its subordinate claim. This contravenes the rules established in "the Boyd case, its antecedents and its successors", as announced in *Case* v. *Los Angeles Lumber Co.*, 308 U. S. 118.

The respondent argues (p. 18) that this line of cases applies only to a reorganization and not to "an adjustment such as is here under consideration". This argument overlooks the statute itself, which reads (§725 (3)):

> "that the plan * * * is fair and equitable as an adjustment, affords due recognition of the rights of each class of creditors and stockholders and fair consideration to each class thereof adversely affected, and will conform to the law of the land regarding the participation of the various classes of creditors and stockholders".

"The law of the land regarding the participation of various classes of creditors and stockholders" is the *Boyd* line of cases. Congressional recognition of this is shown by the following quotations in connection with the introduction of the Railroad Adjustments Act:

> "The bill provides that the plan must conform to the requirements of the law of the land with reference to the participation of stockholders and creditors, and this provision, where used in section 77, has been interpreted to require that the plan must conform to the principles of *Northern Pacific Railway Co.* v. *Boyd,* 228 U. S. 482." (Report of the House Committee on the Judiciary dated March 31, 1939, to accompany H. R. 5407.)
>
> "It is not the intention of these amendments to make inapplicable the principles of *Northern Pacific*

Railway Co. v. *Boyd* (228 U. S. 482)." (Report of the Senate Committee on Interstate Commerce dated May 24, 1939, to accompany H. R. 5407.)

The mortgage priority upon the road and its earnings is completely dislocated by the plan, which gives an actual priority of payment to the subordinate creditor-stockholder, leaving the bondholders to wait twenty years for their payment. This dislocation is equally apparent, by whatever name we call it: whether reorganization, rearrangement, or adjustment. The *Monon* case applies this principle to any new arrangement of the debt.

> "This is based upon the familiar rule that the stockholders' interest in the property is subordinate to the rights of creditors; first, of secured, and then of unsecured creditors, and *any arrangement of the parties* by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation" (*Louisville Trust Co.* v. *Louisville &c. Ry.*, 174 U. S. 674, 684).

The plan is also in direct contravention of *Case* v. *Los Angeles Lumber Company, supra,* because of the absence of any showing of an equity beyond the First Consolidated Bonds. Without an appraisal, the Court below could not exercise "an informed, independent judgment" as to whether any equity existed, as a condition prerequisite to confirmation (*National Surety Co.* v. *Coriell,* 289 U. S. 426, 436, relied upon in the Los Angeles Lumber Company case; *First National Bank* v. *Flershem,* 290 U. S. 504, 525-526; *In re Philadelphia and Reading Coal & Iron Co.,* 105 Fed. (2) 256, 357-358).

Obviously, the Interstate Commerce valuation for rate-making purposes of $12,337,133, is no measure of fair or actual value, unless supported by earnings. The recognized and most realistic basis of valuation in a railroad reorganization is the capitalized earning power of the road

(Bonbright on "Valuation of Property", Vol. II, pp. 880-881; *In re Chicago, Great Western Railway Co.*, 29 Fed. Supp. 149, 159; *Chicago & N. W. Ry. Co.* v. *Eveland*, 13 Fed. (2) 442).

The average earnings of Peoria & Eastern for the past ten years were $170,301, which is 1⅜% upon the rate-making valuation of I.C.C.; clearly indicating that the rate-making valuation is scarcely even evidentiary of true value. In other words, the respondent would multiply the annual earnings by 72 in order to get true value; whereas, even in the height of the boom days, security values did not exceed 15 to 25 times annual earnings.

Probably 20 times earnings is the most favorable to the railroads that anybody could estimate, which would give a valuation of $3,406,020. In order to produce a value even equal to the $4,722,300 of outstanding first consolidated bonds, one would have to multiply the average annual earnings more than 27 times; and in order to get even a slim value on the common stock remaining outstanding, we would have to multiply average earnings 72 times to produce any true value to support the plan. Such figures are astronomic, have no realism, and have no evidence or finding to support any value beyond the First Consolidated Bonds.

II

The charge is that Peoria & Eastern was the mere instrumentality of Big Four and New York Central, that the parent corporations used their dominating position to divert assets and earnings, and that until, after a proper accounting, restitution is made, these parent corporations are not in equity entitled to the large benefits they received under the Adjustment Plan.

The Operating Agreement of 1890 provided that the parent corporation

> "at its own cost and expense shall and will keep up and maintain * * * all said rolling stock and equipment in good working order, and restore and renew all parts thereof as may be necessary to that end".

Said obligation was assigned to the Mortgage Trustee as additional security for the First Consolidated Mortgage Bonds. The parent corporation disregarded said obligation by permitting 400 cars originally costing $515,000 to be retired and not restored. Peoria & Eastern's brief (p. 15) concedes this. This wasted and diverted the mortgage security to the damage of $106,000 annually in excessive per diem rentals.

Peoria & Eastern's brief rationalizes by claiming, first, that New York Central kept its books in accordance with Interstate Commerce regulations (Brief, pp. 14-15), which claim, if true, is wholly irrelevant; and, secondly, that New York Central does not owe the amount in the "equipment retirement account", but that it merely "affords an accounting measure" to represent the equipment which the parent corporation must turn over to Peoria & Eastern upon the termination of the Operating Agreement (Respondent's Brief, p. 22). They say that "the retirement account does not represent an amount now due" (id. p. 22). This claim is not consistent with Paragraph First of the Operating Agreement, that the parent company "*at all times* * * * at its own cost and expense shall and will keep up and maintain * * * all said rolling stock and equipment in good order and restore and renew all parts thereof as may be necessary to that end".

Nor is the statement that the New York Central does not owe the money consistent with the record, as follows:

> "7. * * * and the New York Central, as lessee from the Big Four, is holding for the benefit of the Peoria and Eastern $513,431.65 in an equipment retirement account and $768,710.44 in an equipment depreciation account" (Plan, p. 18).

Mr. Clancy's testimony states the matter simply.

> "Q. Mr. Clancy, you are the Assistant Comptroller of the New York Central and of the Big Four and of the Peoria and Eastern? A. I am" (Minutes, p. 83).
>
> "Q. So far as the equipment retirement account of $514,000 and the equipment depreciation account of $768,000 are concerned, are these accounts carried by the New York Central? A. As liabilities to the Peoria and Eastern.
>
> Q. In other words, the New York Central owes that money to the Peoria and Eastern? A. Correct" (Minutes, p. 236).

Regarding the Equipment Depreciation Account of $768,000, that was a deduction from the gross earnings of Peoria & Eastern as part of its operating cost and should have been kept as security by it or by the Mortgage Trustee to whom the operating agreement had been assigned. Instead it was set up as an unsecured claim against New York Central, although it is the product of the mortgaged rolling stock. Peoria & Eastern's brief admits (p. 15) that this is set up "on account of the loss of service life of equipment still in existence".

Regarding the Betterment Account of $1,806,493 charged against Peoria & Eastern, the Operating Agreement requires the New York Central to supply reasonable betterments at its own cost and expense, and the Supplement to the Operating Agreement provides that no advances should be chargeable against the First Consolidated Mortgage or its bondholders.

It is conceded in the respondent's brief (p. 16) that the 6% on the Retirement and Equipment Accounts, which upon the record were debts unconditionally due, were offset by New York Central against interest on the advances which were payable only out of profits—of which, except in one year, there were none.

The diversion of $1,121,000 of the pledged Springfield lien from the Trustee for the First Consolidated Bondholders, the pledgee, to pay other debts and obligations of Peoria & Eastern receives no explanation in the respondent's brief.

The basic authorities upon the Instrumentality Rule and the effect of inequitable conduct of a parent corporation as precluding it from receiving the equitable benefits of a reorganization, are set forth in our petition and have received no specific reply.

III

Here, the charge is that although the Railroad Adjustments Act authorizes only temporary adjustments of overdue debts, fundamental changes were made, involving: a twenty-year extension of the mortgage debt; a keeping alive, as a charge against future earnings, the parent corporation's past operating losses, which, in any event, were not to be charged against the First Mortgage Consolidated Bondholders or their security; and the permanent wiping out for the future the "Supplement to Operating Agreement" which precludes similar charges against the First Consolidated Mortgage Bondholders, thereafter accruing.

Against this, the respondent apparently concedes that this is no temporary adjustment, but argues that Chapter 15 of the Bankruptcy Act is not a mere moratorium statute and is not limited to a requirement that the postponement of maturities must be temporary only.

We must consider Chapter 15 in the light of the fact that there exists Chapter 77 for making permanent adjustments in railroad securities. We must also consider the simple language of §710 (2) (b):

> "that such corporation's inability to meet its debts, matured or about to mature, is reasonably expected to be temporary only."

Inability to meet its matured debt is to be temporary only—what can that mean except that there must be an inability to meet its debt with a delay that is temporary only? What can that mean except that the plan must be proposed to meet the matured debt with a delay that is temporary only? How does the corporation show an ability to meet its overdue mortgage debt within such temporary period if it postpones the debt without interim payments for twenty years and makes other fundamental changes in the security. According to the Report of the House Committee on Judiciary (p. 4), Chapter 15 is applicable where the Company "is in need of temporary relief only."

This Court denied certiorari in two cases under Chapter 15: *Goetz* v. *Baltimore & Ohio R. Co.*, 309 U. S. 654, and *Steelman* v. *Wichita Falls & S. R. Co.*, 309 U. S. 687. Respondent cites these cases (p. 3) as though they might have bearing either upon the interpretation of Chapter 15 or upon the inequities of the plan. But these cases presented only the narrow question of whether assents obtained before the filing of the petition could be counted in making up the required percentage of assents. This question under Section 77B had already been decided in the affirmative in *Campbell* v. *Allegheny Corp.* (75 Fed. 2d 947, cert. denied 296 U. S. 581), and did not involve any question of public interest.

The respondent argues also that provision for a sinking fund out of earnings would impair the obligation of the junior income bonds. If so, this emphasizes the need of a complete reorganization under Section 77, because, obviously, the right of the senior bondholders to a lien upon the earnings to meet their overdue debt, cannot be impaired by any provision in a junior lien.

However, no such point was urged by the income bondholders. Indeed, the parent corporation is arguing the case of the junior lienors, forgetting that its claim to its

advances, past and future, plus interest thereon, is wedged between the senior and junior lien and pipes off all the earnings over simple interest on the first mortgage debt.

Nor must it be overlooked that $1,121,000 of the pledged Springfield lien is diverted from the purpose of the pledge and utilized to satisfy obligations other than those specified in the pledge. No more fundamental or permanent impairment of a mortgage lien can be imagined than diverting part thereof to pay other creditors. And may a Federal Court validate such expropriation as a temporary adjustment?

It is respectfully submitted that the Writ of Certiorari should be granted.

Dated: New York, N. Y., October 22, 1940.

DONALD N. GILBERT, HAROLD C. YEAGER,
and GEORGE A. CAREY, Petitioners,
By SCRIBNER & MILLER,
ALFRED E. SMITH, JR.,
Solicitors of Petitioners.

MARK HYMAN,
Counsel for Petitioners.

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1940

No. 466.

DONALD N. GILBERT, HAROLD C. YEAGER, and GEORGE A. CAREY, constituting the First Mortgage Bondholders' Protective Committee for The Peoria and Eastern Railway Company's First Consolidated Mortgage 4% Bonds due April 1, 1940,

Petitioners,

against

THE PEORIA AND EASTERN RAILWAY COMPANY and WILLIAM CARNEGIE EWEN, LEWIS L. CLARKE and MAURICE D. ADAMS, as the Peoria and Eastern Railway Company Income Bondholders' Protective Committee,

Respondents.

ANSWER TO REPLY OF RESPONDENT, THE PEORIA AND EASTERN RAILWAY COMPANY, TO PETITIONERS' MOTION FOR DIMINUTION OF RECORD.

Petitioners agree to the printing of the following exhibits requested by said respondent:

Exhibit 4—Excerpt from Minutes of Special Meeting of Stockholders of Peoria & Eastern;

Exhibit 24—Supplement to the Income Bondholders' Indenture;

Exhibit V—Memorandum of Settlement; and

Exhibit X—Statement of Re-Audits; but petitioners believe that to complete the last two exhibits Exhibit W must also be printed, and therefore respectfully request its inclusion in the printed record.

Petitioners also agree to the printing of the Minutes enumerated by Peoria & Eastern, but to complete the matter therein included, the minutes of Mr. Place's testimony should commence with the last question on page 136 instead of at page 140, and the minutes of Mr. Clancy's testimony should include the questions and answers found at pages 83 and 236 of the Minutes, as set forth in the within Reply Memorandum for Petitioners.

Petitioners respectfully object to the printing of the following exhibits requested by Peoria & Eastern, for the following specified reasons:

Exhibits 18 and 19—

For the reason that these two deeds are fully summarized in the Special Court's findings numbered 6 and 7.

Exhibits K to Q—

These are excerpts from minutes of meetings of Board of Directors of Big Four in 1889 and 1890. The essence of these minutes is contained in the 1889 Reorganization Agreement which is the first three pages of Exhibit S, already to be included in the record.

Part of Exhibit S—

This deals with the distribution of the securities to have been issued in 1890 by Peoria & Eastern, and has no relevancy on the issues presented, as no objection has been made to this distribution. In addition, the actual distribution and history

of the bond issues of Peoria & Eastern are fully set forth in the Special Court's findings numbered 1 to 17.

Exhibit 51—

This exhibit consists of twenty lengthy financial statements of Peoria & Eastern submitted to Central Hanover Bank & Trust Company as Trustee for the Income Bondholders, for each year from 1920 to 1939 inclusive. The statements of the last ten years are reflected in Exhibit 35, already to be included in the record. The only purpose stated by respondent for including these twenty statements is to evidence the fact that annual accounts were filed by Peoria & Eastern pursuant to the requirements of the Income Bondholders' Indenture. This fact is in no wise contested, and in any event is proved by the testimony of the witness Harrigan (Minutes, p. 256), which the respondent proposes to include in the record and to which inclusion petitioners have no objection.

Therefore, in addition to the papers to be included in the record as enumerated in petitioner's motion, there should also be included the following portions of the record:

Exhibit 4—

Excerpt from Minutes of Special Meeting of Stockholders of Peoria & Eastern, approving Plan of Adjustment;

Exhibit 24—

Supplement to Income Mortgage Indenture;

Exhibit V—

Memorandum of Settlement;

Exhibit W—

Big Four's Statement of Income and Deductions from Income for Year 1919;

Exhibit X—

Statement of Re-Audits;

Testimony:

Witness Harrigan, Minutes, p. 256; Witness Voorhees, Minutes, pp. 118-129; Witness Place, Minutes, last question on page 136 to middle of page 146; Witness Clancy, Minutes, last line of pages 208 and 209, and the aforementioned parts on pages 83 and 236.

The Income Bondholders' Committee (No. 467) joins in this answer. Respondent, Peoria & Eastern, has made no objection to the printing of a joint record.

Dated: New York, N. Y., October 22, 1940.

Respectfully submitted,

DONALD N. GILBERT, HAROLD C. YEAGER,
and GEORGE A. CAREY, Petitioners,
By SCRIBNER & MILLER,
ALFRED E. SMITH, JR.,
Solicitors of Petitioners.

MARK HYMAN,
Counsel for Petitioners.

Vol 311

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CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1940

No. 467

WM. CARNEGIE EWEN, LEWIS L. CLARKE, M. D. ADAMS and GEORGE E. WILE, as members of a duly constituted Income Bondholders' Protective Committee,

Petitioners,

against

THE PEORIA AND EASTERN RAILWAY COMPANY and DONALD N. GILBERT, HAROLD C. YEAGER and GEORGE A. CAREY, constituting the First Mortgage Bondholders' Protective Committee for The Peoria and Eastern Railway Company's First Consolidated Mortgage 4% Bonds due April 1, 1940,

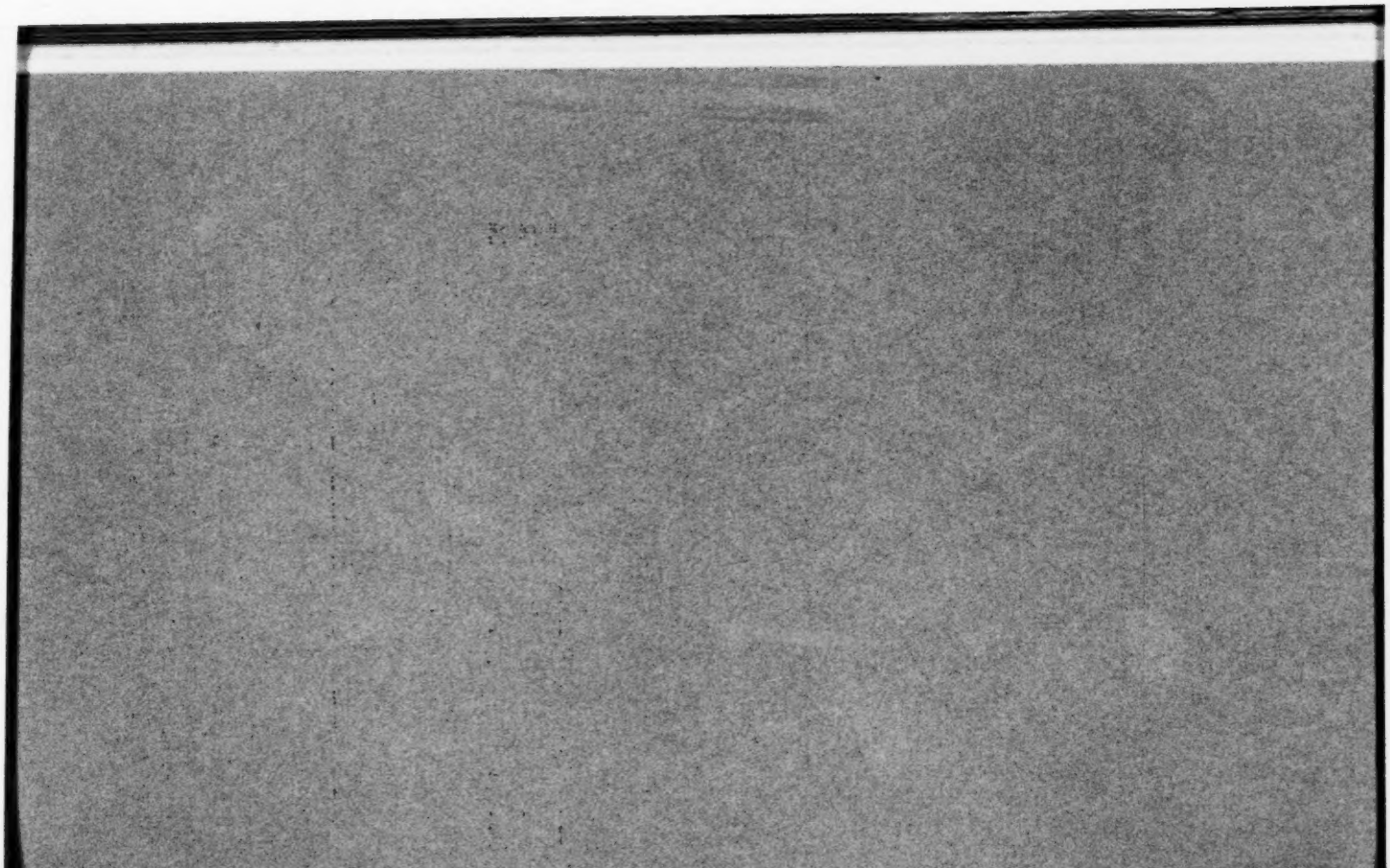
Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK AND BRIEF IN SUPPORT THEREOF

AND

MOTION FOR DIMINUTION OF RECORD

CHARLES S. ARONSTAM,
Counsel to Petitioners.



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IN THE

Supreme Court of the United States

OCTOBER TERM, 1940

No.

WM. CARNEGIE EWEN, LEWIS L. CLARKE, M. D. ADAMS and GEORGE E. WILE, as members of a duly constituted Income Bondholders' Protective Committee,

Petitioners,

against

THE PEORIA AND EASTERN RAILWAY COMPANY and DONALD N. GILBERT, HAROLD C. YEAGER and GEORGE A. CAREY, constituting the First Mortgage Bondholders' Protective Committee for The Peoria and Eastern Railway Company's First Consolidated Mortgage 4% Bonds due April 1, 1940,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK.

To the Honorable, the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Your petitioners respectfully show to the Court as follows:

Petitioners Wm. Carnegie Ewen, Lewis L. Clarke and M. D. Adams were duly appointed by the holders of Income

Bonds of the Peoria and Eastern Railway Company as a Protective Committee to represent their interests in these proceedings. Petitioner George E. Wile, the owner of $114,000 of said Income Bonds, subsequently became a member of said Committee.

This is a petition for a writ of certiorari to review the decree made and entered on the 29th day of July, 1940, of the District Court of the United States for the Southern District of New York, sitting as a Special Court of three Judges, consisting of Learned J. Hand, Circuit Court Judge, John M. Woolsey and Murray Hulbert, District Court Judges, convened pursuant to Section 713 of Chapter XV of the Bankruptcy Act in the manner provided by Section 266, as amended, of the Judicial Code, approving, as modified by the Special Court,* a Plan of Adjustment under Chapter XV of the Bankruptcy Act for the extension of the date of maturity from April 1, 1940, to April 1, 1960, of a part of the principal of the First Consolidated Mortgage Bonds of the Peoria and Eastern Railway Company and *for the renewal and modification of the Operating Agreement between the Peoria and Eastern Railway Company and the Cleveland, Cincinnati, Chicago and St. Louis Railway Company* which expired on April 1, 1940.

Jurisdiction.

The decree of the Special Court to be reviewed was entered on July 29, 1940.

The jurisdiction of this Court is invoked under Section 745 of Chapter XV of the Bankruptcy Act (Title II, U. S. C. A., §1245).

Note: A motion is made herewith for the diminution of the record; consequently references in this petition and brief are to the original exhibits and other documents.

* The Plan of Adjustment was modified so as to provide that the Income Bondholders shall, so long as the Income Bonds remain unpaid, have one director upon the Board of Directors.

Summary Statement of the Matter Involved.

The Peoria and Eastern Railway Company (hereinafter referred to as the "Peoria Company") was organized on February 20, 1890, to acquire certain railroad properties formerly of the Ohio, Indiana and Western Railway Company (hereinafter referred to as the "Ohio Company") which owned a line of railroad extending from Pekin, Illinois, through Indianapolis, Indiana, to Springfield, Ohio, of approximately 337 miles which was then in foreclosure. Prior to the foreclosure proceedings a plan of reorganization was formulated by and under the supervision of the Cleveland, Cincinnati, Chicago & St. Louis Railway Company (hereinafter referred to as the "Big Four").

The plan of reorganization of the Ohio Company was effectuated in the following manner:

1. The portion of the railroad extending from Pekin, Illinois, to Indianapolis, Indiana, of approximately 201 miles, was conveyed to the Peoria Company, subject to two mortgages aggregating $1,500,000 (hereinafter referred to as "prior liens").

2. The portion of the railroad extending from Indianapolis, Indiana, to Springfield, Ohio (hereinafter referred to as the "Springfield Division"), of approximately 136 miles, was conveyed to the Big Four for and in consideration of the sum of $5,000,000 represented by a Purchase Money Lien in that amount maturing on April 1, 1940, and bearing interest at 4%, which Purchase Money Lien was thereafter transferred to and became the property of the Peoria Company.

3. For the foregoing properties, including the Purchase Money Lien, the Peoria Company issued the following securities:

(a) $7,930,000 of First Consolidated Mortgage Bonds out of an authorized issue of $10,000,000, bearing interest at 4%, maturing on April 1, 1940;

(b) $4,000,000 of Income Mortgage Bonds bearing interest at the rate of 4% per annum, which was to be non-accumulative and payable only out of the net earnings and income of the Peoria Company, maturing on April 1, 1990;

(c) 100,000 shares of capital stock of the Peoria Company of the par value of $100 each, of which 50,000 shares were given to the Big Four, which subsequently acquired by purchase an additional share of stock. The balance of the shares of stock, together with the First Consolidated Bonds and Income Bonds, were distributed among the former security holders of the Ohio Company.

4. The Big Four and the Peoria Company entered into an agreement granting to the Big Four the exclusive and absolute right to use and operate the properties of the Peoria Company for a period of fifty years from April 1, 1890, to April 1, 1940, *"and for such further time thereafter as it may elect."* This agreement* (hereinafter referred to as the "Operating Agreement") provides as follows:

> (a) The Big Four shall *at its own cost and expense* furnish all rolling stock, equipment, repairs and supplies necessary to operate the railroad; keep and maintain said line, rolling stock and equipment in good working order; restore and renew all parts; pay all taxes; and *indemnify and save harmless the Peoria Company from any and all claims arising out of its operation and management* (Par. First, Appendix A, p. 33).
>
> (b) The Big Four shall provide and make good any deficiency in the fund necessary to pay interest on the prior bonds and on the First Consolidated Bonds and guarantees that the net earnings and the income of the Peoria Company operated by *it* shall be not less than $412,200 per annum (Par. Second, Appendix A, p. 34).

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*The Operating Agreement (Exhibit 26) is printed as Appendix A hereto, page 31.

(c) The Big Four shall receive all the earnings and income from the use and operation of the Peoria Company's properties. The net earnings derived therefrom, after deducting operating expenses, to be applied, first, to the payment of interest on the prior liens and the First Consolidated Bonds; second, to reimburse the Big Four for any advances made under the Operating Agreement in any previous year; third, apply the balance to the payment of interest on the Income Mortgage Bonds; and fourth, to pay any amount finally remaining to the Peoria Company (Par. Third, Appendix A, p. 35).

(d) The Big Four shall look *only to the future net earnings of the line operated by it* and to the income from the Purchase Money Lien for reimbursement to it of any sums which it may advance in compliance with its guarantee (Par. Fifth, Appendix A, p. 37).

All the documents, agreements, etc., embodying the foregoing, were simultaneously executed on February 22, 1890.

On February 25, 1890 (three days after the documents were executed), the then President of the Big Four, M. E. Ingalls, summarized the transaction between the two companies as follows:

> "The general result of all these papers was that this Company (the Big Four) acquires the ownership or is granted the lease or right to operate all the railway property formerly of the O. I. & W. Railway Company at a net rental of $412,200" (Exhibit O).

Thus the Big Four obtained complete control of the railway properties formerly of the Ohio Company and by reason of its acquisition of 50,001 shares of the capital stock of the Peoria Company obtained complete control and domination of the affairs and management of the Peoria Company, its lessor.

Subsequently, by lease dated January 22, 1930, the Big Four leased to the New York Central, for the term of ninety-

nine years, all its lines of railroad and other properties, and transferred to the New York Central its rights under the Operating Agreement, and the New York Central assumed the obligations thereunder. The New York Central owns 96% of the stock of the Big Four.*

The Peoria Company, the Big Four and the New York Central have common directors, officers and counsel. The Peoria Company was not independently represented in these proceedings except in so far as the officers and counsel of the Big Four and the New York Central purported to represent the Company.**

Status of the Peoria Company on April 1, 1940.

1. The $5,000,000 Purchase Money Lien on the Springfield Division became due and payable by the Big Four to the Peoria Company.

2. The prior liens of the Peoria Company aggregating $1,346,000 became due and payable.

3. The First Consolidated Bonds of the Peoria Company aggregating $8,376,000 became due and payable.

4. The term specifically set forth in the Operating Agreement expired. The New York Central and the Big Four claimed there was due and owing to them on account of advances made under said agreement the sum of $2,485,482.58.†

5. Acting on the assumption that it had the inalienable right to renew the Operating Agreement for a further term, the Big Four with the New York Central, on March 30, 1940, addressed a letter (Exhibit 49)†† to the Peoria Company

---

* The foregoing history is set forth in Findings of Special Court Nos. 1 to 19, incl.

** The Special Court recognized the dual and conflicting relationship between the three companies and the possibility of abuse therefrom, and by reason thereof provided in its decree that the Income Bondholders were to have one director on the Board of Directors.

† Of this sum, $1,806,493.18 represents maintenance, additions and betterments, $522,517.24 represents accrued interest and $11,006.02 represents interest paid on funded debt (Exhibit I, Findings of Special Court No. 27).

†† Findings of Special Court No. 33.

(which it controlled) electing to renew the Operating Agreement from April 1, 1940, to April 1, 1960.

6. The Peoria Company had no funds to meet its maturities except from the proceeds of the $5,000,000 Purchase Money Lien.

RESULT: For forty out of the fifty years of the operation of the Peoria Company's properties under the Operating Agreement by the Big Four, the Income Bondholders received no interest on their bonds.

Proceedings Before the Interstate Commerce Commission.

On January 25, 1940, the Peoria Company applied to the Interstate Commerce Commission, pursuant to Chapter XV of the Bankruptcy Act, for authority to modify its First Consolidated Bonds, by making a cash payment of 45% thereof and by extending the maturity date for twenty years from April 1, 1940, of the unpaid principal amount with interest at the existing rate of 4% per annum.

On February 3, 1940, in a separate proceeding, the Big Four and the New York Central applied to the Commission under Section 5(4) of the Interstate Commerce Act for (1) approval and authority to renew the Operating Agreement from April 1, 1940, to April 1, 1960, with certain modifications (Exhibit 33); and (2) for authority to assume obligation and liability in respect to the interest on $4,722,300 reduced principal amount of the extended First Consolidated Bonds.

The decision of the Commission approving both applications was predicated upon the assumption, and so recorded in its decision, that there was no opposition to the Plan of Adjustment and to the renewal of the Operating Agreement.

Proceedings in the United States District Court.

Thereafter, in pursuance of the provisions of Section 710 of Chapter XV, the Peoria Company applied to the District Court for approval and confirmation of the Plan of Adjustment.

This Court fixed the date for hearing on said Plan of Adjustment for April 29, 1940, at which time petitioners applied for intervention in the proceedings. The application was granted and an order of intervention was duly made and entered on May 8, 1940. The Peoria Company did not solicit the written consents of the Income Bondholders to the Plan of Adjustment and the renewal of the Operating Agreement, and such consents were not secured.

Plan of Adjustment.

The Plan of Adjustment, as set forth in Exhibit 5, provides that:

(1) Upon the Plan becoming effective, the Big Four would pay the $5,000,000 * Purchase Money Lien on the Springfield Division, to be applied to the liquidation of the outstanding prior liens, and the balance on account of the First Consolidated Bonds which matured on April 1, 1940, reducing the unpaid principal to $4,722,300. These bonds as reduced to be extended to April 1, 1960, with interest at the rate of 4%.

(2) The continued use and operation of the Peoria Company's properties by the New York Central and the Big Four from April 1, 1940, to April 1, 1960, pursuant to the right of election of the Big Four as contained in the Operating Agreement with certain modifications.†

(3) The advances which have been made by the Big Four and the New York Central to the Peoria Company under the Operating Agreement (amounting as of December 31, 1939, to $2,485,482.58) to continue their existing status under the Operating Agreement as a prior lien to the Income Bonds.

* This $5,000,000 has since been paid and applied to the satisfaction of the prior liens and to the reduction of the First Consolidated Bonds as proposed in the Plan.

† The agreement evidencing the extension provides that the guarantee of the Big Four with respect to net earnings shall be reduced from $412,200 to an amount sufficient only to pay interest on the First Consolidated Bonds as reduced ($188,892), and that all expenses in connection with equipment, additions and betterments shall be borne by the Peoria Company (Exhibit 33).

(4) The holders of the Income Mortgage Bonds of the Peoria Company to continue their status under the Income Mortgage, subject to the First Consolidated Mortgage Bonds as modified and extended, and to the Operating Agreement as extended.

Questions Presented and Specification of Errors.

1. The Special Court erred in exceeding its power and authority under Chapter XV of the Bankruptcy Act in passing upon and considering as a part of the Plan of Adjustment of the First Consolidated Mortgage Bonds the right of the Big Four to a renewal of the Operating Agreement.

2. The Special Court erred in construing the provision in the Operating Agreement that *"the Cleveland Company (the Big Four) shall and will henceforth and during the period of fifty years from April 1, 1890, and for such further time thereafter as it may elect"* gave to the New York Central and the Big Four the right to renew the Operating Agreement for a specified term of twenty years in the light of the settled law that such provisions are of no force and effect in law by reason of uncertainty.

3. The Special Court erred in holding that the Big Four had a right to charge the Peoria Company for advances made for the maintenance and operation of the Company's properties in excess of the Company's net earnings, in that the Operating Agreement specifically provided that the Big Four would *at its own cost and expense* furnish all rolling stock, equipment, repairs and supplies necessary to operate the railroad and keep and maintain the *same in good order and save the Peoria Company free and harmless from any and all claims arising out of its operation and management.*

4. The Special Court erred in holding that the Income Bondholders were not adversely affected by the Plan of Adjustment in accordance with Section 706 of Chapter XV of the Bankruptcy Act insofar as said Plan provided for the extension of the Operating Agreement for a specified term

of twenty years and the continuance of the non-negotiable unsecured inter-company debt of $2,485,482.58 as a prior obligation to the Income Bonds.

5. The Special Court erred in drawing inferences of fact and being influenced in its decision by the threats of the New York Central that, in the event the Plan were not approved, including the extension of the Operating Agreement, it would probably withdraw its deposit of $5,000,000 for the satisfaction of the Purchase Money Lien on the Springfield Division, resulting in the foreclosure of the property, and would divert its traffic therefrom over its other lines, resulting in inevitable bankuptcy of the Peoria Company, when in truth and in fact the New York Central never intended to default on the Purchase Money Lien and has since paid the same.

6. The Special Court erred in disregarding the dual and conflicting relationship existing between the Big Four and the Peoria Company in construing the Operating Agreement more favorably to the Big Four than the construction placed upon said agreement by the Big Four at the time it was made.

7. The Special Court erred in finding that the Plan was fair and equitable as an adjustment, afforded due recognition and fair consideration to the Income Bondholders, and conformed to the law of the land regarding the participation of the various classes of creditors.

Reasons for Allowance of Writ.

1. The Special Court has so disregarded the statutory prohibitions limiting its jurisdiction, has so completely ignored the well settled and established rules of law, and has so far departed from the accepted course of judicial proceedings as to call for an exercise of this Court's power of supervision.

a. The Special Court construed the terms and provisions of the Operating Agreement contrary to well-established rules of law.

b. The Special Court allowed itself to be improperly swayed and influenced by the threats of the New York Central that, if the Plan of Adjustment were not approved and the Operating Agreement renewed, the $5,000,000 Purchase Money Lien would not be paid by the Big Four, the Springfield Division would revert to the Peoria Company, and its traffic would be diverted therefrom to other lines operated by the New York Central, resulting in inevitable bankruptcy for the Peoria Company.

2. The Income Bondholders were adversely affected by the Plan of Adjustment and their consent should have been secured thereto in the manner provided in Chapter XV of the Bankruptcy Act.

3. This is the first review from the decree of the Special Court and the only method allowed under Section 745 of Chapter XV of the Bankruptcy Act and, if this petition is denied, the Income Bondholders will not have been afforded any opportunity for a review of the decree of the Special Court.

4. If this petition is denied, the Income Bondholders will be barred from ever contesting the right of the Big Four to extend the Operating Agreement for a period of twenty years and the termination of the claim of the Big Four for its alleged advances, which advances would otherwise be extinguished with the expiration of the Operating Agreement, thus permanently impairing the security of the Income Bonds and precluding the payment of interest thereon for a further period of twenty years.

Prayer for Writ.

WHEREFORE, petitioners respectfully pray that a writ of certiorari be issued under the seal of this Court, directed to the District Court of the United States for the Southern District of New York, to the end that this cause may be reviewed and determined by this Court and the decree of the District Court of the United States may be reversed, and that petitioners may have such other and further relief as this Court may deem proper in the premises.

Dated: New York City, September 25, 1940.

WM. CARNEGIE EWEN, LEWIS L. CLARKE, M. D. ADAMS and GEORGE E. WILE, as members of a duly constituted Income Bondholders' Protective Committee,

By CHARLES S. ARONSTAM,
Counsel.

IN THE

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OCTOBER TERM, 1940

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WM. CARNEGIE EWEN, LEWIS L. CLARKE, M. D. ADAMS and GEORGE E. WILE, as members of a duly constituted Income Bondholders' Protective Committee,

Petitioners,

against

THE PEORIA AND EASTERN RAILWAY COMPANY and DONALD N. GILBERT, HAROLD C. YEAGER and GEORGE A. CAREY, constituting the First Mortgage Bondholders' Protective Committee for The Peoria and Eastern Railway Company's First Consolidated Mortgage 4% Bonds due April 1, 1940,

Respondents.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

I

The Opinion of the Court Below.

The opinion of the Special Court of the United States District Court for the Southern District of New York has not yet been officially reported. It is printed as Appendix B hereto at page 39.

II

Jurisdiction.

The statement of jurisdiction is contained in the petition for certiorari and by reason thereof is not repeated here.

III

Statement of the Case.

The statement of the facts is contained in the petition for certiorari and by reason thereof is not repeated here.

IV

Specification of Errors.

The specification of errors are contained in the petition for certiorari and by reason thereof are not repeated here.

ARGUMENT

Summary of Argument.

POINT A. The Special Court exceeded its jurisdiction as defined and prescribed in Section 700 of Chapter XV of the Bankruptcy Act in passing upon and approving the right of the New York Central and the Big Four to renew the Operating Agreement with the Peoria Company, in connection with the Plan of Adjustment for part of its mortgage indebtedness.

POINT B. The Special Court erred in holding that, under the terms of the Operating Agreement, the New York Central and the Big Four had the inalienable right to elect to continue said Agreement for a further period of twenty years after its expiration on April 1, 1940.

POINT C. The Special Court erred in holding that, under the terms of the Operating Agreement, the New York Central and the Big Four had the right to charge the Peoria Company for monies expended for the maintenance and operation of its properties in excess of its net earnings.

POINT D. The Special Court erred in holding that the Income Bondholders were not adversely affected by the Plan of Adjustment in accordance with Section 706 of Chapter XV of the Bankruptcy Act, and that by reason thereof their written consent to the said Plan was not necessary.

POINT E. The Special Court erred in finding that the Plan was fair and equitable as an adjustment, afforded due recognition and fair consideration to the Income Bondholders, and conformed to the law of the land regarding the participation of the various classes of creditors.

POINT F. The Special Court erred in drawing inferences of fact, giving consideration to and being influenced by the threats of the New York Central that, in the event the Plan were not approved, it would withdraw its deposit of $5,000,000 in satisfaction of the Purchase Money Lien on the Springfield Division and would re-route its traffic therefrom over other lines, which would result in inevitable bankruptcy for the Peoria Company.

POINT A

The Special Court exceeded its jurisdiction as defined and prescribed in Section 700 of Chapter XV of the Bankruptcy Act in passing upon and approving the right of the New York Central and the Big Four to renew the Operating Agreement with the Peoria Company, in connection with the Plan of Adjustment for part of its mortgage indebtedness.

Section 700 of Chapter XV provides as follows:

> "Sec. 700. In addition to the jurisdiction otherwise exercised, courts of bankruptcy shall exercise original jurisdiction, as provided in this chapter, for postponements or modifications of debt, interest, rent, and maturities or for modifications of the securities or capital structures of railroads."

The Income Bondholders do not object to the Plan of Adjustment insofar as it provides for the application of the $5,000,000 received in satisfaction of the Purchase Money Lien on the Springfield Division from the Big Four, toward the payment of the prior liens and the reduction and extension of the respondent's First Consolidated Bonds in the manner provided for in the Plan, but they do object to that portion of the Plan which makes the renewal and modification of the Operating Agreement *conditio sine qua non* to the payment of said monies by the Big Four.

Chapter XV of the Bankruptcy Act did not intend nor contemplate the extension of the jurisdiction of the Special Courts convened thereunder to inquire into or pass upon any question except the adjustment of a railroad's capital structure.

Judge Chestnut in *In re Baltimore & Ohio Railroad Company*, 29 Fed. Supp. 608, states as follows with respect to the purposes of Chapter XV:

> "Other provisions of the Act indicate quite clearly that its purpose is to provide relief for railroads which

> are only temporarily financially embarrassed and whose general earning capacity has not been so seriously impaired as to require the more drastic reorganization and modification of its debt structure provided for in Section 77 of the Bankruptcy Act" (p. 612).

In the instant case the Peoria Company in its Plan of Adjustment sought, in addition to an adjustment of its First Consolidated Bonded indebtedness, the approval and sanction for a renewal of an operating agreement with the New York Central and the Big Four which does not come within the limitations prescribed in Section 700 of Chapter XV.

POINT B

The Special Court erred in holding that, under the terms of the Operating Agreement, the New York Central and the Big Four had the inalienable right to elect to continue said agreement for a further period of twenty years after its expiration on April 1, 1940.

The provision contained in the Operating Agreement for its renewal is invalid for uncertainty and is of no force or effect.

Paragraph First of the Opening Agreement, among other things, provides:

> "* * * the Cleveland Co. shall and will henceforth and during the period of fifty years from April 1st, 1890, *and for such further time thereafter as it may elect*, use and operate said 'Indiana part' and said 'Illinois part' as railways * * *" (Appendix A, p. 33). (Italics ours.)

Acting upon the assumption that it had the inalienable right to renew the Operating Agreement for such further term as it may elect, the Big Four, jointly with the New York Central, addressed a letter (Exhibit 49)* to the Peoria Com-

* Findings of Special Court No. 33.

pany, exercising said election. The letter advises the Peoria Company that, upon the proposed Plan of Adjustment, or a modification thereof, becoming effective, the Big Four will enter into an extension agreement with the Peoria Company evidencing said election from April 1, 1940 to April 1, 1960.

The State Courts have uniformly held that such provisions as contained in the Operating Agreement for a renewal and/or extension have no legal effect by reason of their uncertainty.

In *Western Transportation Co.* v. *Lansing,* 49 N. Y. 499, an action was brought upon a similar covenant in a lease. The lease was for a term of fifteen years and contained the following provision:

> "with privilege of keeping and occupying said lots *for such further time, after the expiration of said term, as said party of the second part* (*lessee*) *shall choose or elect*" (p. 500). (Italics ours.)

At the termination of the lease the tenant demanded a lease for a further term of fifteen years, and, upon being refused, sued for specific performance.

The Court said:

> "Thus considered we have a provision for further occupation, which by its terms definitely settles the amount of the rent, and, to an extent, the time for the payment of it; but by placing the length of time of such further occupation in the choice or election of the lessee, leaves it, *a priori,* entirely uncertain and indeterminate; and which precludes the implication from the provisions of the lease of anything as to these matters" (p. 504).
>
> * * * * * *
>
> "If we treat these provisions as a covenant on the part of the lessor for a new lease, the question arises, is it valid and enforceable, or is it void for uncertainty; specific performance of which may not be adjudged? It has been held that where no term is fixed by the covenant, it is void for uncertainty (*Abeel* v. *Radcliff,* 13 J. R. 296)" (p. 504).

The doctrine enunciated in *Western Transportation Co.* v. *Lansing, supra,* was approved and followed in *Gaswell Service, Inc.* v. *Sinclair Refining Co.*, 240 App. Div. (New York) 240.

In *Howard* v. *Tomicick*, 81 Miss. 703, a lease was made for one year with the clause "with privilege of longer."

The Court said at page 708:

> "The question is whether a lease of premises of one year 'with privilege of longer,' secures to the lessee right of renewal of the lease at his option. We think it does not. It is too vague and uncertain to constitute a binding covenant."

In *O'Reilly* v. *Frye*, 263 Mass. 318, the Court said:

> "The agreement of the parties made the term of the tenancy determinable at the will of the lessee. Such a tenancy 'must, in law, be at the will of both parties'" (citing cases) (p. 320).

In *Pidgeon* v. *Richards*, 4 Ind. 374, the Court had before it the following clause "to occupy so long as he desires":

> "The substance of that instrument is, that it gives to *Richards* the right to occupy and improve the land in question for a certain consideration, payable as he occupies, as long as he shall please to do so. It gives him no absolute interest which he can convey to another on vacating the premises himself. Whenever he removes from them, his right in them ceases. And he is not bound to occupy them and pay the consideration a day longer than he sees fit to do so. He has, in short, under the instrument, an estate in the land at his own will. Such being the character of the instrument, the case is easily disposed of.
>
> Lord *Coke*, in his first Inst., 55*a*, says: 'It is regularly true, that every lease at will must in law be at the will of both parties, and, therefore, when the lease is made, to have and to hold at the will of the lessor, the law implyeth it to be at the will of the lessee also; for it cannot be onely at the will of the lessor, but it must be at the will of the lessee also. And so

> it is when the lease is made to have and to hold at the will of the lessee, this must be also at the will of the lessor, and so are all the bookes that seeme *prima facie* to differ, clearly reconciled.'
>
> This law of Lord *Coke's* day continues to be the law of the present day" (pp. 375, 376).

See also:

> * *Idalia Realty Development Co.* v. *Norman*, 232 Mo. 663;
>
> *Delashmutt* v. *Thomas*, 45 Md. 140.

Williston on Contracts, Rev. Ed., Vol. 1, states as follows:

> "§43. One of the commonest kind of promises too indefinite for legal enforcement is where the promisor retains an unlimited right to decide later the nature or extent of his performance. This unlimited choice in effect destroys the promise and makes it merely illusory" (p. 123).

There is nothing in the Operating Agreement which specified or made certain the terms and conditions upon which the agreement was to be continued, *or the term for which the Big Four was to enjoy a further occupation after the original term expired.* The Special Court in its opinion, despite the foregoing authorities, construed the clause in the Operating Agreement "as giving the 'Big Four' an option pending the term to extend it for a specified period in the future. (Whether more than one such extension was contemplated we need not decide.)" In support of its contention the Special Court cited *Say* v. *Smith*, 1 Plowden 269 (Appendix B, p. 42).

In *Western Transportation Co.* v. *Lansing, supra,* the Court discussed *Say* v. *Smith, supra,* and held that said case was not applicable to the provision under discussion, which is similar in all respects to the language employed in the Operating Agreement.

> "Now it may not seem that in principle, there is any distinction between a contract for a lease for so many

* This case cited and approved *Western Transportation Co.* v. *Lansing*, 49 N. Y. 499.

years as I. S. shall name, and one for so many years as the lessee shall name. It may be that there is not. We are not here called upon to say how it is. The clause in the contract before us does not provide to that effect. *By it the occupation is not for such further time after the expiration of the first term as the lessee shall name. He is not by it before or when he begins that occupation to name and specify the number of years for which he will continue as tenant. But the occupation is to run along without a determined continuance specified beforehand; and is for its duration, dependent all the while upon his choice or election, unexpressed as to a definite term thereof, so that it may continue indefinitely, and be arrested whenever he wills.* * * *" (p. 508). (Italics ours.)

The opinion of the Special Court holding that the Big Four had the right to renew the Operating Agreement for a period of twenty years is contrary to and disregards the settled law as enunciated in the foregoing cases. Counsel has found no decision in the State courts sustaining the Court's reasoning nor was counsel for the Peoria Company in the proceedings before the Special Court able to cite any authority to sustain the right of the Big Four to elect to renew the Operating Agreement for twenty years.

*If the Operating Agreement expired on April 1, 1940, then simultaneously therewith the advances alleged to have been made by the New York Central and the Big Four thereunder in the sum of $2,485,482.58 became extinguished.** The Spe-

* Paragraph Fifth of the Operating Agreement provides:

"FIFTH.—The Cleveland Co. shall and will look *only* to such *future net earnings of said lines of railroad operated by it* under these presents and such future income of said purchase money lien, as shall not be required for the payment of said interest on said prior bonds and on said First Consolidated Mortgage Bonds, and hereinabove guaranteed by it, *for the reimbursement to it* of any sums it may advance in compliance with its aforesaid covenants and agreements, and the Peoria Co. hereby charges all such future net earnings and income coming to it, its successors or assigns, not required for the payment of said interest, with the payment of all such advances of the Cleveland Co., with interest upon said advances at the rate of six per cent. per annum" (Appendix A, p. 37). (Italics ours.)

cial Court concurred in this view in its opinion: "It is true that by so doing the New York Central will be able to recoup for its past advances out of future income, a privilege which would have otherwise ended on April 1, 1940" (Appendix B, p. 42).

POINT C

The Special Court erred in holding that, under the terms of the Operating Agreement, the New York Central and the Big Four had the right to charge the Peoria Company for monies expended for the maintenance and operation of its properties in excess of its net earnings.

Under the Operating Agreement, the Peoria Company granted to the Big Four: (1) *the exclusive right to use and operate all of its properties* (Par. First); (2) the right to receive all the earnings and income derived from the Peoria Company's properties operated by it (Par. Third).

In return for the foregoing privileges, the Big Four agreed *at its own cost and expense:* to keep and maintain said railroad in good working order; pay all taxes and indemnify and save harmless the Peoria Company from any and all claims arising out of its operation and management (Par. First). The Big Four further *agreed to provide and make good any deficiency* necessary to pay interest on the prior bonds and on the First Consolidated Bonds and guaranteed that the net earnings and the income of the Peoria Company would not be less than $412,200 per annum (Par. Second).

It is now claimed that, as of December 31, 1939, the respondent is indebted to the New York Central and the Big Four in the sum of $2,485,482.58, of which $1,806,493.18 represents maintenance and additions-betterments and $552,517.24 represents accrued interest thereon (Exhibit 1).*

The provision of paragraph Third of the Operating Agreement, upon which the Big Four relies for reimbursement, in no way nullifies the specific provisions of paragraph First.

* Findings of Special Court No. 27.

Reference in paragraph Third to the sources of the company's earnings, the formula to determine the net income and its application, was intended solely as a measuring rod to ascertain the net income of the Peoria Company and the amount of the advances, if any, to be supplied by the Big Four on account of interest on the prior bonds and First Consolidated Bonds.

The agreement entered into between the Reorganization Committee of the Ohio Company and the Big Four on the 30th day of October, 1889 (Exhibit S), excludes any other construction than that advanced by the Income Bondholders. In that agreement the Big Four undertook to:

> "guarantee that the net earnings and income of the Western Company (Peoria Company) derived from both said lines shall not be less than $412,200 a year, to be increased by the sum of $40 a year for each and every of said First Consolidated Mortgage Bonds issued in excess of $9,430,000 of said bonds, as provided in said plan of reorganization, and that the Cleveland Co. *shall look only to future surplus net earnings and income of the Western Company derived from both said lines for its reimbursement of any sums advanced to make good any deficiency in said net earnings and income, with interest at six per cent. per annum.*" (Italics ours.)

And it further undertook to:

> "maintain said Western line (Peoria Company) and the rolling stock necessary for the operation of said Western line, and pay all taxes thereon, or upon the earnings or income of said Western line, as well as rentals or other like charges, and to indemnify and save harmless said Western Company from all claims arising out of the operation or management thereof."

Although provision was made for reimbursement to the Big Four on account of the advances to make good any deficiency in the net earnings of the Peoria Company, *no provision was made for reimbursement on account of the Big Four's undertaking to maintain the Peoria Company's properties.*

The statement of the President of the Big Four, made to his Board of Directors on February 25, 1890, three days after the execution of the Operating Agreement, further supports the Income Bondholders' construction.

> "* * * the general result of all these papers was that this Company (the Big Four) acquires the ownership or is granted the lease or right to operate all the railway property formerly of the O. I. & W. Railway Company at a net rental of $412,200" (Exhibit O).

The language of an instrument is to be construed against the person who proposes it rather than the person who is invited to accept it. The interpretation by the President of the Big Four of all the instruments executed on February 22, 1890, including the Operating Agreement, should be the standard of interpretation to be adopted by the Court. See *Gillette* v. *Bank of America*, 160 N. Y. 549, at page 555. The foregoing principle was reaffirmed by Judge Cardozo in the case of *Becker* v. *Frassee & Co.*, 255 N. Y. 10, at page 14.

Thus, the Special Court in its opinion erred in stating,

> "All we now hold is that the covenant to maintain the road and to make additions to its equipment, did not contemplate gratuitous advances, and that the third article allowed recoupment for so much as was properly expended" (Appendix B, p. 45).

In its decree the Special Court attempted to meet the objections raised by both Bondholders' Protective Committees as to the validity of these advances by providing:

> "Section 24. All questions concerning the amount and validity of the accounts between the Big Four, the New York Central Railroad Company and the Petitioner are not determined in these proceedings and are hereby specifically left open and reserved for future determination. Should the New York Central Railroad Company and/or the Big Four seek or attempt, in any year or at any time or times hereafter, to withdraw any part of the earnings or assets of the

Petitioner by way of recoupment or repayment of said inter-company accounts, then and in such event said New York Central Railroad Company and/or Big Four must prove and establish their right to do so" (Decree, p. 10).

This provision, however, does not meet the objection that these advances had no legal basis in fact or in law and were extinguished with the expiration of the Operating Agreement.

POINT D

The Special Court erred in holding that the Income Bondholders were not adversely affected by the Plan of Adjustment in accordance with Section 706 of Chapter XV of the Bankruptcy Act, and that by reason thereof their written consent to the said Plan was not necessary.

Section 706 of Chapter XV of the Bankruptcy Act reads as follows:

> "SEC. 706. No creditor shall be deemed to be 'affected' by any plan unless such plan proposes a modification of the evidence of debt or other instrument defining the rights of such creditor, or a modification of the security, if any, for the claim of such creditor."

It must be conceded that, if the New York Central and the Big Four do not have the right to renew the Operating Agreement, then the Income Bondholders are adversely affected by the renewal of said Agreement. The provisions of the Operating Agreement supersede the provisions of the Income Mortgage as to the ascertainment of the interest, if any, payable on the Income Bonds, and the rights of the Income Bondholders are wholly controlled thereby. If there is no right of election on the part of the Big Four the Income Bondholders would not be subject or subordinate to any new Operating Agreement unless they consented thereto.

Even assuming the right to renew the Operating Agreement for a further period of twenty years, the New York Cen-

tral and the Big Four have elected to renew the Operating Agreement, not upon the same terms and conditions as contain in the original agreement, but with certain modifications. The agreement evidencing the renewal of the Operating Agreement (Exhibit 33) provides that the guaranty with respect to the net earnings of the respondent shall be reduced from $412,200 to $188,892, an amount sufficient only to pay interest on the First Consolidated Bonds as reduced and extended under the Plan, and that all expenditures in connection with the replacements, additions and betterments shall be charged against the Peoria Company instead of assumed by the New York Central in accordance with paragraph First of the Operating Agreement.

The renewal of the Operating Agreement with the modifications hereinabove set forth is a modification of an instrument defining the rights of the Income Bondholders, and adversely affects their interests.

The Special Court found that the Income Bondholders were not affected by the Plan (Findings of Special Court No. 41). For the reasons hereinabove set forth, it is respectfully submitted that the written consent of the Income Bondholders should have been secured in the manner provided in Sections 710 and 725 of Chapter XV, as their interests are adversely affected by the Plan of Adjustment.

POINT E

The Special Court erred in finding that the Plan was fair and equitable as an adjustment; afforded due recognition and fair consideration to the Income Bondholders; and conformed to the law of the land regarding the participation of the various classes of creditors.

Chapter XV requires as a condition to the approval of the Plan that it shall be found "in the public interest and *in the best interests of each class of creditors* and stockholders" (Sec. 710), and "that the plan is fair and equitable as an adjustment, affords due recognition to the rights of each class

of creditors and stockholders and fair consideration to each class thereof adversely affected and will conform to the law of the land regarding the participation of various classes of creditors and stockholders" (Sec. 725).

The Plan of Adjustment, as promulgated by the New York Central through its wholly controlled and dominated subsidiary the Peoria Company, does not comply with the foregoing provisions with respect to the interests of the Income Bondholders.

It is estimated that, assuming the continuance of the general basis of earnings and expenses which prevailed in 1939, the Peoria Company should show a corporate income for 1940 of $304,727 which is to be applied as follows: $188,892 for interest on the First Consolidated Bonds as reduced and $83,000 for interest to the New York Central at the rate of 6% on account of its alleged advances (Exhibit 41). The balance thereof will be used to reduce the principal amount of these advances. In no event, however, by reason thereof, will the Income Bondholders receive any interest for the next twenty years.

On the foregoing estimates the New York Central will not be required to advance any money on account of its guarantee of interest to the First Consolidated Bondholders as the earnings will be ample to pay same. The New York Central will be receiving all the benefits derived from the Operating Agreement without paying any consideration therefor.

Such an adjustment is not in the best interests of the Income Bondholders and does not afford to them due recognition and fair consideration.

The Plan of Adjustment does "not conform to the law of the land regarding the participation of the various classes of creditors and stockholders" as enunciated in *Case* v. *Los Angeles Lumber Products Co.*, 308 U. S. 106.

In the instant case, priority is given to the New York Central and the Big Four for the repayment of their unsecured advances with interest at 6% out of the earnings of the Peoria Company (which advances under the Operating Agreement were not to be an obligation of the Peoria Com-

pany). In other words, recognition and priority is given to a doubtful unsecured non-negotiable debt over a secured negotiable debt. In addition, the stockholders of the Peoria Company (the New York Central owning 51% of the stock) receive undue favor and in effect are given priority to the Income Bondholders under the Plan by participating therein without any change in their status.

In truth and in fact the purpose of the Plan of Adjustment is not to aid the Peoria Company through a temporary financial embarrassment, but to subordinate the Income Bondholders to the interests of the New York Central in the Peoria Company, as represented by the Operating Agreement, its alleged advances and its majority stock ownership, for a period of twenty years.

POINT F

The Special Court erred in drawing inferences of fact, giving consideration to and being influenced by the threats of the New York Central that, in the event the Plan were not approved, it would withdraw its deposit of $5,000,000 in satisfaction of the Purchase Money Lien on the Springfield Division and would re-route its traffic therefrom over other lines, which would result in inevitable bankruptcy for the Peoria Company.

Counsel for the Peoria Company, speaking for the New York Central and the Big Four which he also represented, in his brief and in his oral argument in the Court below, repeatedly advised the Court that, if the Plan were not confirmed, the Big Four would probably withdraw its deposit of $5,000,000 for the satisfaction of the Purchase Money Lien on the Springfield Division and the New York Central would re-route its traffic therefrom over other lines controlled by it which would result in bankruptcy for the Peoria Company. That the Special Court was unduly influenced by these veiled

threats is indicated from the following excerpt from its opinion:

> "The New York Central probably will, and lawfully may, withdraw its deposit of $5,000,000 because the "Big Four" never undertook to pay the lien. That well may result in the foreclosure of the lien, and that in turn will subject the Springfield Division to the first consolidated mortgage since it covers the lien. But it is impossible now to say what in that event will be the net income of the two divisions, and how it will compare with the fixed charges. No present figures could throw any light upon that question because the result would be a dismemberment of the system; for the New York Central could route its freight by other rails, and might do so, if the bondholders, being in possession of both divisions, would not come to terms" (Appendix B, p. 48).

The Supreme Court in *Case* v. *Los Angeles Lumber Products Co., supra,* recently condemned such threats as employed by the New York Central:

> "The District Court's further finding that if the bondholders were to foreclose now they would receive 'substantially less than the present appraised value' of the assets of the debtor corporation is no support for inclusion of the old stockholders in the plan. The fact that bondholders might fare worse as a result of a foreclosure and liquidation than they would by taking a debtor's plan under §77B can have no relevant bearing on whether a proposed plan is 'fair and equitable' under that section. Submission to coercion is not the application of 'fair and equitable' standards" (p. 123).
>
> * * * * * *
>
> "Threats by stockholders of the kind here in question are merely threats to the jurisdiction of the court, which jurisdiction these selfsame stockholders invoked for their benefit when they caused the debtor's petition to be filed. Consequently, these claims of the stockholders are, as we have said, entitled to no more dignity than any claim based upon sheer nuisance value" (p. 130).

The writ of certiorari to the United States District Court for the Southern District of New York should be granted.

Respectfully submitted,

CHARLES S. ARONSTAM,
Counsel to Petitioners.

CHARLES S. ARONSTAM,
ARCHIE S. KARP,
of Counsel.

APPENDIX A

Operating Agreement.

THIS INDENTURE, made this twenty-second day of February, one thousand eight hundred and ninety, by and between the CLEVELAND, CINCINNATI, CHICAGO AND ST. LOUIS RAILWAY COMPANY, party of the first part (hereinafter called the Cleveland Co.), and the PEORIA AND EASTERN RAILWAY COMPANY, party of the second part (hereinafter called the Peoria Co.), WITNESSETH:

WHEREAS the Peoria Co. has acquired a line of railroad extending westward from the boundary line between the States of Illinois and Indiana to Pekin, in the State of Illinois, together with rights and interests in the tracks and other property of the Peoria and Pekin Union Railway Company, hereinafter called the "Illinois part" of said line of railroad, and has also acquired a leasehold interest in a line of railroad extending from the boundary line between the States of Illinois and Indiana to the tracks of the Indianapolis Union Railway Company in or near Indianapolis, in the State of Indiana, with the right to use the tracks and certain other property of the Indianapolis Union Railway Company, hereinafter called the "Indiana part" of said line of railroad, and which said lines of railroad were formerly the property of the Ohio, Indiana and Western Railway Company, and which said "Illinois part" and "Indiana part" are subject to the lien of a certain mortgage to secure bonds known as Preferred Bonds of the Indiana, Bloomington and Western Railway Company for one million dollars, executed by said last named company on or about the 15th day of April, 1879, to the Central Trust Company of New York as trustee, and also subject to the lien upon said "Illinois part" and said "Indiana part," as well as upon the line of railroad extending from Indianapolis, Indiana, to Springfield, in the State of Ohio, formerly belonging to the

said Ohio, Indiana and Western Railway Company, for five hundred thousand dollars of preferred bonds secured by a mortgage executed by the Ohio, Indiana and Western Railway Company to the Central Trust Company of New York, as trustee, bearing date the second day of April, one thousand eight hundred and eighty-eight; and

WHEREAS the Peoria Co. has issued a certain series of its First Consolidated Mortgage Bonds, dated February 22d, 1890, for an aggregate amount of $10,000,000 payable on the first day of April, 1940, at its office or agency in the City of New York, with interest thereon from the first day of April, 1890, at the rate of four per cent. per annum, payable semi-annually at said office or agency in accordance with coupons for such interest annexed to said bonds, and has secured the payment of said bonds by a first mortgage of all its corporate property and franchises to the Central Trust Company of New York and Charles W. Fairbanks of Indianapolis as trustees, and which said first mortgage and said prior mortgages are superior to these presents; and is about to issue a certain series of its Income Mortgage Bonds dated February 22d, 1890, for an aggregate amount of $4,000,000, payable in 100 years, and bearing interest at not exceeding four per cent. per annum, and non-cumulative, payable when and only if, and to such extent, as earned, beginning April 1, 1891, and annually thereafter, out of the net earnings of the property, and is about to secure the payment of said last mentioned bonds by a second mortgage of all its corporate property and franchises, to said Central Trust Company of New York and Charles W. Fairbanks as trustees, and which said second mortgage shall be subject to these presents:

AND WHEREAS the railways of the parties hereto connect at Indianapolis, and it will be beneficial to the business and traffic of said railways that the same be put under one management:

NOW, THEREFORE, THESE PRESENTS WITNESS, that the Cleveland Co., in consideration of the premises, and of one dollar

to it in hand paid by the Peoria Co., the receipt whereof is hereby acknowledged, hereby contracts and arranges with the Peoria Co. for running the railroad of the Peoria Co. as follows:

FIRST.—The Peoria Co. hereby grants unto the Cleveland Co., its successors and assigns, subject to said first consolidated mortgage and to said prior mortgages, the right to use and operate that portion of its railroad known as the "Illinois part," and the Cleveland Co. agrees that it shall and will from henceforth and during the term herein limited, use, maintain and operate said "Illinois part" upon the terms and conditions herein prescribed; and the Peoria Co. hereby also assigns and transfers, subject to said first consolidated mortgage and said prior mortgages, for the period during which these presents shall continue, its leasehold interest in said "Indiana part," and all the rolling stock and equipment of the Peoria Co. and which said rolling stock and equipment shall be considered as included in said "Indiana part" whenever said "Indiana part" is herein mentioned or referred to; *and the Cleveland Co. shall and will henceforth and during the period of fifty years from April 1st, 1890, and for such further time thereafter as it may elect, use and operate said "Indiana part" and said "Illinois part"* as railways in such manner as to satisfy the requirements of law in the States and jurisdictions in which the same are or shall at any time be situated, *itself providing and furnishing at its own cost and expense, all other rolling stock and equipment, labor and supplies necessary for that purpose; and also at all times during its said use and operation thereof, also at its own cost and expense shall and will keep up and maintain all said "Indiana part" and said "Illinois part" of said line of railroad and all said rolling stock and equipment in good working order, and restore and renew all parts thereof as may be necessary to that end; and also shall and will pay all taxes on said "Indiana part" and said "Illinois part" of said line of railroad* or upon the earnings or income thereof, as well as rentals reserved, or other like charges, payable for such use in respect of any part or parts thereof; *and also shall and will*

indemnify and save harmless the Peoria Co. from any and all claims arising out of the operation or management thereof; and also at its own cost and expense shall and will do, perform and comply with all and singular the covenants, terms and conditions accepted or undertaken by the Peoria Co. in the conveyances, deeds and leases to it of the same or of any parts thereof, or in said mortgages so given by it to secure said bonds, excepting always the payment of the principal of said bonds, or of said prior bonds, it being understood and agreed that the Cleveland Co. does not assume the payment of such principal or any part of it.

SECOND.—The Cleveland Co. hereby covenants and agrees to and with the Peoria Co., its successors and assigns, and to and with all and singular the persons and parties who may at any time be or become the holders of the bonds secured by said first consolidated mortgage hereinbefore mentioned, or of any of them *that it shall and will provide for and make good any deficiency which may at any time occur in the fund necessary for the due and punctual payment as it accrues of the interest on the two series of bonds secured by the said prior mortgages hereinbefore mentioned and of the interest on all of the said First Consolidated Mortgage Bonds of the Peoria Co.* which may at any time be outstanding, and of any tax or taxes which the Peoria Co. may be required to pay or retain from said interest on any of said bonds (it being understood and agreed that said interest is to be paid without deduction for any such tax or taxes), after devoting to such payment of interest the net income which may arise from the purchase money lien of five millions of dollars on that part of the railroad formerly of the Ohio, Indiana and Western Railway Company between Indianapolis, Indiana, and Springfield, Ohio, and the net earnings derived from said "Indiana part" of said line of railroad and the net earnings derived from said "Illinois part" of said line of railroad; *and the Cleveland Co. guarantees that the net earnings and income from said three sources, so actually applied to the payment of said interest, shall not be less than four hundred and*

twelve thousand two hundred dollars in each and every year of the fifty years for which it by these presents undertakes the use and occupation of said "Indiana part" of said line of railroad; and it further agrees that such guaranty shall be increased by the sum of forty dollars in each and every year for each and every one thousand dollars of said First Consolidated Mortgage Bonds issued in excess of nine million four hundred and thirty thousand dollars; and that the Peoria Co. may transfer and assign the covenants contained in this second clause of these presents and all benefits thereof to the trustees of said mortgage executed by it as aforesaid to secure its said First Consolidated Mortgage Bonds, and that upon such transfer and assignment, said covenants shall be deemed and taken to be a direct and absolute obligation and guaranty of the Cleveland Co. to the said trustees and to all and singular the persons and parties, who may at any time be or become the holders of said First Consolidated Mortgage Bonds or of any of them, for the payment of all the interest to accrue thereon and on the bonds secured by said prior mortgages, as and when it shall become payable, and that the Cleveland Co. shall, if thereunto requested by the trustees of said First Consolidated Mortgage, execute and deliver to them and by way of further assurance, a separate and independent covenant and agreement to the effect hereinabove provided.

THIRD.—*The Cleveland Co. is to receive all earnings and income of the use and operation of said "Indiana part" and of said "Illinois part" of said line of railroad, and of said rolling stock and equipment*, and apply the net earnings of each year arising from the same (to be ascertained by deducting from the earnings and income of the year from its use and operation of said "Illinois part" and said "Indiana part," the expenses of operation and maintenance during such year, including taxes, assessments, insurance, rental and other like charges, and the cost of repairs, renewals and reasonable betterments to the said "Illinois part" and the said "Indiana part," necessary for their economical and efficient operation), together with the net income from the

purchase money lien of $5,000,000 on the part of the railroad formerly of the Ohio, Indiana and Western Railway Company between Indianapolis, Indiana, and Springfield, Ohio, to the payment of the interest as and when it shall mature and become payable upon the said two series of bonds, secured by prior mortgages upon said line of railroad, to wit: $1,000,000 of bonds issued by the Indiana, Bloomington and Western Railway Company and $500,000 of Preferred Bonds issued by the Ohio, Indiana and Western Railway Company, and to the payment of the interest as and when it shall become payable upon said First Consolidated Mortgage Bonds of the Peoria Co. After reimbursing itself out of what shall remain of such net earnings and income of the year, not applied as aforesaid to the payment of interest, for any advances hereunder in any previous year remaining unpaid to it (with interest thereon at the rate of six per cent. per annum), the Cleveland Co. shall apply the balance of said net earnings and income to the payment of interest upon said Income Mortgage Bonds according to the requirements of the mortgage securing the same, and pay over to the Peoria Co. any amount thereof finally remaining. It is understood and agreed that the Cleveland Co. is to be entitled to make the customary charge for the use of any and all additional rolling stock and equipment furnished by it as hereinbefore provided for use on said lines of railroad from time to time, and that such charge shall form part of and be included in the expense of operation hereunder.

FOURTH.—Within sixty days after the 31st of December, 1890, and each year thereafter, the Cleveland Co. is to make up and state all its receipts for earnings and income from the said lines of railroad operated by it under these presents, and from said purchase money lien, and all its disbursements for interest or rental as aforesaid, and for the cost and expense of using, operating and maintaining said lines of railroad and of complying with the requirements of these presents, and to render proper accounts thereof to the Peoria Co. and to the trustees of its said second mortgage as in said second mortgage required.

AND THESE PRESENTS FURTHER WITNESS THAT:

FIFTH.—*The Cleveland Co. shall and will look only to such future net earnings of said lines of railroad operated by it* under these presents and such future income of said purchase money lien, as shall not be required for the payment of said interest on said prior bonds and on said First Consolidated Mortgage Bonds, and hereinabove guaranteed by it, *for the reimbursement to it of any sums it may advance in compliance with its aforesaid covenants and agreements,* and the Peoria Co. hereby charges all such future net earnings and income coming to it, its successors or assigns, not required for the payment of said interest, with the payment of all such advances of the Cleveland Co., with interest upon said advances at the rate of six per cent. per annum.

SIXTH.—The Peoria Co. shall permit and suffer the use of its name by the Cleveland Co. in the use and operation of said lines of railroad, and in the acquisition of any and all property to be acquired for the purposes thereof.

SEVENTH.—Upon default by the Cleveland Co. in any act or thing by it to be done or performed under these presents, the Peoria Co., its successors or assigns, may resume the use and operation of its said lines of railway without prejudice to or impairment of the covenants and guaranty hereinabove expressed. All personal or real property paid for out of the earnings or income of the Peoria Co. is to become and remain its property, and the Cleveland Co. undertakes that whenever this present contract or arrangement shall terminate, it shall and will restore to the Peoria Co. rolling stock and equipment adapted for use on its lines of railroad of at least the value of the rolling stock and equipment leased to it by these presents.

IN WITNESS WHEREOF, said parties hereto have caused their respective corporate seals to be to these presents affixed, and the same to be signed by their respective presidents and secretaries the day and year first above written.

THE CLEVELAND, CINCINNATI, CHICAGO AND ST. LOUIS RAILWAY COMPANY,

[SEAL.] By M. E. INGALLS,
President.

Attest:
E. F. OSBORN,
Secretary.

THE PEORIA AND EASTERN RAILWAY CO.,

[SEAL.] By J. A. BARNARD,
President.

Attest:
W. W. LYNN,
Secretary.

Signed and delivered in the presence of (as to The Cleveland, Cincinnati, Chicago & St. Louis Railway Company):

JOSEPH MOSES,
F. H. LOVETT.

Signed and delivered in the presence of (as to The Peoria and Eastern Railway Company):

FRANK J. RICHMANN,
EDWARD C. RUMPLER.

APPENDIX B

Opinion of the Special Court.

DISTRICT COURT OF THE UNITED STATES,

FOR THE SOUTHERN DISTRICT OF NEW YORK.

WILLIAM CARNEGIE EWEN, and others,
Intervenors,
against
THE PEORIA & EASTERN RAILWAY COMPANY,
Petitioner.

DONALD N. GILBERT, and others,
Intervenors,
against
THE PEORIA & EASTERN RAILWAY COMPANY,
Petitioner.

Before:

L. HAND, Circuit Judge,
WOOLSEY and HULBERT, District Judges.

This cause comes on upon a hearing under §720 of the Bankruptcy Act, of a petition filed by the Peoria & Eastern Railway, for confirmation of a "plan of adjustment" filed under §710. Two committees of security holders have intervened under §720: that of Ewen and others, representing the "income bondholders"; and that of Gilbert and others, representing a minority of the first consolidated mortgage bondholders. Both object to confirmation, though not for the same reasons. The evidence was taken before a court con-

stituted under §713; and the case was later argued and submitted upon briefs.

JACOB ARONSON and CROSBY J. BEAKES, for the petitioner;

CHARLES S. ARONSTAM and ARCHIE S. KARP, for the income bondholders;

LOUIS G. BERNSTEIN, JULIUS J. ROSENBERG, LEONARD B. FRUTKIN and WILLIAM J. REINHART, JR., for the first mortgage bondholders.

L. HAND, C. J.: The facts are sufficiently stated in the report of the Interstate Commerce Commission, (March 27, 1940), passing upon the plan, and we shall accept it as the background for our discussion. The objections are chiefly because the plan disregards rights originally secured to the intervenors in the reorganization of the Ohio, Indiana & Western Railroad, a mortgage upon which was foreclosed in 1889. On the sale under the decree in that suit Coster and Spencer, who were acting for a committee of the old bondholders, bought in the property and effected a reorganization by a series of documents all dated February 22, 1890, implementing an earlier agreement of October 30, 1889. The general outline of the reorganization was that the Ohio, Indiana & Western Railway, which had been operating a road from Peoria, Illinois, to Springfield, Ohio, should be divided into two parts at the City of Indianapolis. The "Big Four" railroad—now controlled by the New York Central—bought in the eastern part in fee—which we shall call the Springfield Division—paying for it by giving to Coster and Spencer a lien upon it of $5,000,000, due on April 1, 1940, the principal of which it did not bind itself to pay, though it guaranteed the interest at four per cent. The western part of the road —which we shall call the Illinois-Indiana Division—Coster and Spencer conveyed to a new corporation, the Peoria & Eastern, the petitioner here. That is to say, they conveyed the fee of that part which was in Illinois, and they leased in perpetuity that part which was in Indiana, conveying the reversion later. (Why this curious device as to the Indiana

part was adopted, does not appear.) The petitioner paid for the Illinois-Indiana Division in bonds and shares of the new road, delivered to Coster and Spencer and by them presumably distributed among the old bondholders of the Ohio, Indiana & Western Railway. The "Big Four" bought half the shares and made an operating agreement with the new road by which it was granted the privilege of operating the Illinois-Indiana Division for fifty years, in consideration of which it was to pay all operating expenses, and the interest on the mortgages just issued to Coster & Spencer, as well as that on two mortgages already on the property, one for $500,000 which covered both divisions, and the other for $1,000,000 which covered only the Illinois-Indiana Division. The plan proposes to extend this agreement for twenty years beyond April 1, 1940, and the first question is whether the New York Central has the right to do so against the opposition of the intervenors.

1) The Extension of the Operating Agreement.

The first article of the operating agreement, so far as pertinent, read as follows: "the Cleveland Co. shall and will henceforth and during the period of fifty years from April 1st, 1890, and for such further time thereafter as it may elect, use and operate" the Illinois-Indiana Division. It is possible to construe these words, either as giving the "Big Four" a license to remain in possession for as long as it chose after the expiration of fifty years, or as giving it an option, to be exercised before the expiration of the term, to extend it for another fixed period. The first would result in a mere tenancy at will, terminable by either party, or from year to year, and the income bondholders might in that case be prejudiced by the proposed extension for a fixed term. Substantially similar words were construed in Western Transportation Co. v. Lansing, 49 N. Y. 499, as creating a tenancy at will, or from year to year, and the decision is the intervenors' main reliance. It is to be noted, however, that the court very particularly (p. 508) refused to pass upon whether, if the clause had created an option giving the lessee a privilege pending

the term to extend it for a new, though indefinite period, it would have been invalid; and the decision is therefore at most only an interpretation of the particular lease then before the court. It would not in any case be authoritative upon us, for the property at bar is in the States of Illinois and Indiana, where we have been unable to find any pertinent decisions; but it may be that in the case of an ordinary agricultural lease between individuals, like that there at bar, it is proper to interpret such a privilege as no more than a tenancy at will, or from year to year. On the other hand it seems to us quite inappropriate to adopt the same construction for an operating agreement between two railroads. The relation created involves elaborate and complicated operating adjustments, and to give either road a power to denounce it at will, or even at a year's notice, would put both in a position which, if not intolerable, would at least be extremely instable and unsatisfactory. We therefore construe the clause as giving the "Big Four" an option pending the term to extend it for a specified period in the future. (Whether more than one such extension was contemplated we need not decide.) The fact that the extension was left indefinite, and was to be fixed by the "Big Four", was immaterial; it has been law for over three hundred years that uncertainty in the length of a term at the time of the execution of a contract to grant it, is no objection, if its duration will become certain before it begins. Say v. Smith, 1 Plowden 269. The new term was here certainly for a "reasonable" period, assuming that such a condition was to be implied.

2) Prejudice to the Income Bondholders by the Extension.

What we have just said disposes of the argument that the extension could operate to the prejudice of income bondholders. Their bonds were made expressly subject to the agreement, and, if we are right, that included the power to extend the term. It is true that by so doing the New York Central will be able to recoup for its past advances out of future income, a privilege which would have otherwise ended on April 1st, 1940; but if that was what the agreement intended, no

wrong will be done. The suggestion that the original transaction is now subject to be reopened because the "Big Four" had bought half the Peoria & Eastern Railway's shares is without merit. In the first place, while the agreement was with the Peoria & Eastern, the transactions were in fact with Coster and Spencer, that is, with the old bondholders of the Ohio, Indiana and Western Railway, who presumably dealt with the "Big Four" at arms' length, who, as shareholders, were charged with knowledge of the whole transaction, and who were free to accept any conditions upon the income bonds that they chose. And that aside, we cannot understand how it can be seriously argued that after the lapse of fifty years, the contract should be unravelled, even if there had been substance in the objection at the outset.

3) The Payments Due under the Operating Agreement.

The third article of the agreement provided that the "Big Four" should receive all the income of the Peoria & Eastern Railway, deduct "the expenses of operation and maintenance", taxes and the like, and, out of the "net" income so resulting and any income from the $5,000,000 lien upon the Springfield Division, should pay all interest falling due upon the two prior mortgages and the first consolidated mortgage. If anything were then left, the "Big Four" was to reimburse itself "for any advances hereunder in any previous year remaining unpaid to it (with interest thereon at the rate of six per cent. per annum)", and finally to pay any balance, first to the income bondholders, and after them to the shareholders. This language is unequivocal; it appropriated each year's surplus, to all accumulated advances; the income bonds were to receive nothing until these were all paid. The second article of the agreement contains language which, however, both intervenors insist modified the meaning of the third, and fixed a minimum rental of $412,200, which the "Big Four" was bound to pay, regardless of any reduction in the interest due upon the three mortgages. The passage relied upon was in substance that the "Big Four" agreed that it would "make good any deficiency which may at any time

occur in the fund necessary" to pay the interest, "after devoting to such payment" the "net income" from the purchase-money lien on the Springfield Division, and "net earnings" of the two parts of the Illinois-Indiana Division. It guaranteed—and it is this language which is supposed to create a minimum rental—"that the net earnings and income from said three sources, so actually applied to the payment of said interest, shall not be less than four hundred and twelve thousand two hundred dollars" annually for the whole period of fifty years. (The guaranty included in addition forty dollars for each bond, issued by the Peoria & Eastern above the amount provided at the time, $9,430,000.) It appears to us clear that this was intended only as a guaranty that the income of the road should pay interest on all the bonds outstanding, just as the guaranty of the purchase money lien did that the income of the Springfield Division should pay interest on the lien itself. The text alone demands that conclusion, for the guaranty does not cover generally the net earnings and the income of the road, but only those earnings and that income, when "actually applied to the payment of interest". One cannot apply money in payment of interest upon a cancelled bond. (It is perhaps worth while also to note that the covenant runs not only to the Peoria & Eastern, but to the bondholders as well.) It is true that the "Big Four" got the advantage of operation of the division for no more than a guaranty of its fixed charges; and possibly the bargain was indirectly worth more than that to it, though the actual operation appears to have been at a loss. Be that as it may, if more than a guaranty of the fixed charges had been intended, the parties would surely not have fixed a rental—for in that event there would have been a rental—at such sum as $412,200. That was an absurd sum, unless they were thinking in terms of the fixed charges. Furthermore, if it was a rental, the supposed lessee would normally not have had a charge for any deficit in operation. Both articles seem to us therefore to be harmonious, and to provide that the income bondholders should get nothing except any surplus over all current charges, past and present.

4) The Accounts between the New York Central and the Peoria & Eastern.

Not only has a large operating deficit accumulated against the Peoria & Eastern, but a large "retirement" account and a large "depreciation" account have accumulated in its favor against the New York Central. The plan does not liquidate either of these, and the order of confirmation will leave open all questions touching their amount and validity. If the New York Central seeks in any year to withdraw any part of the earnings by way of recoupment, it must prove its right. All we now hold is that the covenant to maintain the road and to make additions to its equipment, did not contemplate gratuitous advances, and that the third article allowed recoupment for so much as was properly expended. Whether the cross items can be offset, the plan also leaves open.

5) The Use of $500,000 First Consolidated Mortgage Bonds as Security for the Peoria & Eastern's note.

The proceeds of a note of the Peoria & Eastern in favor of a subsidiary of the New York Central, were used to take up the $500,000 of prior bonds that were a lien upon both divisions of the road. The security for this note was $500,000 of the first consolidated bonds and 1730 shares of the Peoria & Pekin Union. The first question is whether the bonds were lawfully pledged under the mortgage, and that depends upon the seventh article. Fifteen hundred thousand dollars of the issue of ten millions was reserved to be issued "as may be necessary for the purposes of exchange for said prior bonds as hereinafter provided"; i. e., "when * * * the Railway Company shall deliver * * * to said Central Trust Company * * * any of said prior bonds * * * Central Trust Company shall issue to the Railway Company * * * an amount of said bonds so reserved equal at par to the amount of the said prior bonds so delivered at par". The argument is that the pledge was not such an exchange, and was therefore invalid. Even so, the lender would be entitled to be subrogated to the old bonds, paid by the borrowed proceeds. Subrogation is a purely equitable doctrine (Restatement of Restitu-

tion, §162); it disregards form, and here, the transaction would have been entirely regular if the following form had been adopted. The lender could have bought the old bonds, holding them without turning them in for cancellation. It could then have surrendered them to the Peoria & Eastern, which could in turn have surrendered them to the trustee of the mortgage in exchange for new bonds, par for par. The Peoria & Eastern could at the same time have delivered the shares of the Peoria & Pekin Union as additional security for any difference in value between the old and the new bonds, for the first consolidated bondholders could not have complained if the road had used its free assets to carry through such a transaction. Since all this would have been entirely lawful, and would not have impaired any rights of the bondholders, equity will effect the same result, even though the form chosen—i. e., a direct pledge of the bonds—was invalid.

The plan properly assumes, therefore, that the pledge was good; and deals with the note by treating $210,000 of the bonds as issued, and paying the remaining $290,000 at par out of the $5,000,000 by which the New York Central will cancel the lien on the Springfield Division. The lender must then release, not only the pledged bonds, but the 1730 shares of the Pekin & Peoria Union. The intervenor suggests that the bonds are now worth 60; if so, although no more than $174,000 should be allotted to the cancellation of the $290,000 of new bonds, the Peoria & Pekin Union shares will account for the balance, $116,000. It is true that the evidence of their value might be better, but it is reasonably apparent that there is nothing unfair in this part of the adjustment.

6) Contribution by the Springfield Division to the Illinois-Indiana Division.

The question as to this is whether the $500,000 prior mortgage upon both divisions should be wholly assumed by the Illinois-Indiana Division, or whether the Springfield Division should contribute ratably to its discharge. The deed of Coster and Spencer to the "Big Four", conveying the Springfield Division, was indeed without warranty, but the question whether a mortgagor who conveys part of the property means

to make the lien a primary incumbrance on what he retains, cannot be answered merely by recourse to the conveyances, or the order of their execution; it must be gathered from the implications of the particular transaction. The operating agreement required the net income from the purchase-money lien on the Springfield Division to be used to pay interest upon all three mortgages, the $500,000 mortgage among them, and therefore as to interest the Springfield Division was certainly not to contribute. The same intent appeared also as to the principal, because, although the first consolidated mortgage did not cover the Springfield Division at all, it provided that new bonds might be exchanged for the bonds of the $500,000 mortgage. Moreover, by the fifth article the Peoria & Eastern promised to "pay at the maturity thereof all principal of such of said prior bonds as shall not have been previously taken up by exchange". Since all the papers were parts of a single transaction and are to be read together, the mortgage was intended to be a burden on the Peoria & Eastern. The intervening first consolidated bondholders deny this; they explain the covenant as merely making it a default under the consolidated mortgage for the Peoria & Eastern not to pay the prior mortgages at their maturity. But if that was the only purpose, it did not require an assumption of the mortgages by the Peoria & Eastern; all that was necessary was to declare that default upon the prior mortgages should be a default upon theirs. Moreover, after any of the old bonds were exchanged for new the lien on the Springfield Division was on any theory pro tanto extinguished. Why should contribution exist only as to those that might not be exchanged? We can see no reason therefore for so circumscribing the significance of the covenant. In any event all these circumstances taken together satisfy us that the lien of the $500,000 prior mortgage was to be upon the Illinois-Indiana Division alone.

7) The Unfairness of the Plan to the First Consolidated Bondholders.

The first consolidated bondholders argue that the extension of the operating agreement is "unfair" within the doc-

trine of Case v. Los Angeles Lumber Products Co., 308 U. S. 106, because it allows the New York Central to recoup out of the income of the Peoria & Eastern properly applicable to the bonds, although the accumulated advances are a junior claim. This, as we have seen, is not a valid position in the mouth of the income bondholders because they took subject to an extension of the operating agreement; but that is not true as to the first consolidated bondholders, and the answer must depend upon other considerations. Under the plan the New York Central guarantees interest for twenty years on the remaining principal of the bonds, and their maturity is extended accordingly. Since this will take only $188,000, and the present estimated income of the road is about $304,000, at first blush the plan appears to create an unlawful priority in favor of junior claims. However, the situation is not so simple. If the plan fails of confirmation, the bondholders will, it is true, be able to foreclose upon the Illinois-Indiana Division immediately, but if they take it in, the debt against it will be not only the whole of the present first consolidated mortgage, but what is left of the prior lien bonds together with the note secured by the pledge. The New York Central probably will, and lawfully may, withdraw its deposit of $5,000,000, because the "Big Four" never undertook to pay the lien. That well may result in the foreclosure of the lien, and that in turn will subject the Springfield Division to the first consolidated mortgage since it covers the lien. But it is impossible now to say what in that event will be the net income of the two divisions, and how it will compare with the fixed charges. No present figures could throw any light upon that question, because the result would be a dismemberment of the system; for the New York Central could route its freight by other rails, and might do so, if the bondholders, being in possession of both divisions, would not come to terms. It is therefore not true to say that there is any assured income applicable to the first consolidated bonds upon foreclosure, which is to be used to pay junior debts. Acceptance of the plan was a question of judgment, which a majority of three-fifths might decide, §725 (2). In fact nearly four-fifths have decided for the plan, and the minority must accede.

9) Fulfillment of the Conditions Prescribed by §725 of the Bankruptcy Act.

It is clear that the situation is not proper for the radical reorganization provided by §77; nobody suggests, for example, that the Peoria & Eastern should be put into the hands of trustees, which that section would require. The road is temporarily embarrassed, but no more. On the other hand, if the plan goes through, there is ground for expectation that the road will be able to meet its debts; its chief difficulty has been the maturity of the first consolidated mortgage. If that can be refinanced as here provided, there is good prospect that the road can go on, and not only serve the public, but meet its debts, as they fall due. It is not likely to become insolvent, for its earnings are more than enough to meet its fixed charges; and, so far as we can see, no future financing will be necessary which will be beyond its powers. We recognize, of course, that these conclusions are conjectural, but that is inevitable. The important fact is that the plan fends off what might very well result in the disruption of an important part of a large transportation system, and does so with proper regard for the rights of all. We have tried to exercise that independent judgment which 1725 (3) requires of us, but it is impossible not to be influenced—e. g., as to the practicability of success—by the findings of the Commission. We do not understand, however, that in this we have been delinquent; quite the contrary, we ought to give great weight to its conclusions upon matters within its expert competence, even though in the end we are indeed charged with final responsibility for the result.

The last paragraph of §725 also requires us to approve the continuation of the existing voting rights in the Peoria & Eastern and in the way in which its directors and officers are selected. We must find that continuation "adequate, equitable, in the best interests of creditors and stockholders, and consistent with public policy". This we understand gives us a free hand in requiring the plan to give such representation as is equitable to the creditors. The income bondholders occupy much the same position as preferred share-

holders, and as such they have a very lively interest in the payment of the accumulated advances. We think that they should have representation upon the road's board of directors, so that they may continually keep advised of its affairs without the mediation of a court. We cannot, however, see any advantage in giving them more than one director, and certainly it would be extremely prejudicial to give them a majority, which is what they ask in case no income is paid on the bonds for two years. That might make joint operation difficult or impossible, and failure to pay interest on these bonds is not a default at all. All they need is some one who will have the absolute right to scrutinize the road's operation, management and finances. Hence we will modify the plan by virtue of the power given us in §721 so as to provide that the income bondholders shall have one director upon the board. This does not require resubmission to the Commission under §721 (a); nor does it substantially affect the interests of any class of creditors so as to require resubmission to any of these under §721 (b). The plan will therefore be modified to that extent and approved as modified.

The expenses of this proceeding are so moderate as to require no discussion.

The petitioner will submit proposed findings and conclusions and a proposed decree within five days after the filing of this opinion. The intervenors will file any supplements or amendments to these within five days thereafter.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1940

No.

WM. CARNEGIE EWEN, LEWIS L. CLARKE, M. D. ADAMS and GEORGE E. WILE, as members of a duly constituted Income Bondholders' Protective Committee,

Petitioners,

against

THE PEORIA AND EASTERN RAILWAY COMPANY and DONALD N. GILBERT, HAROLD C. YEAGER and GEORGE A. CAREY, constituting the First Mortgage Bondholders' Protective Committee for The Peoria and Eastern Railway Company's First Consolidated Mortgage 4% Bonds due April 1, 1940,

Respondents.

MOTION FOR DIMINUTION OF RECORD AND FOR THE PRINTING OF A JOINT RECORD.

Counsel for petitioners herein filed their petition for a writ of certiorari to the United States District Court for the Southern District of New York accompanied by a certified transcript of the record of the proceedings in said District Court. Contemporaneously therewith, counsel for the First Mortgage Bondholders' Protective Committee also filed a petition for a writ of certiorari together with a motion for the diminution of the record.

1. The nature of this case and the questions presented have been set forth in the foregoing petition for a writ of certiorari.

2. The said petition for a writ of certiorari does not request consideration by this Court of all the questions passed upon by the District Court. Many of the facts contained in the testimony and exhibits pertinent to the issues raised in the said petition are set forth in the Findings of the District Court. Petitioners now seek to be relieved of printing those parts of the record of the proceedings below which are not necessary to a consideration of the questions presented by the petition for a writ of certiorari herein or which are contained in the uncontested findings of the District Court.

3. It is respectfully submitted that it would serve no useful purpose to have printed portions of the record below which pertain only to issues raised in the District Court but are not raised herein.

4. The District Court made fifty-three (53) Findings, including, among other things, the detailed history and present status of the Peoria and Eastern Railway Company. Petitioners contest only Findings 36, 41, 43-48, inclusive, and 52, which are in reality conclusions of the District Court. Petitioners are requesting review only of that portion of the Plan of Adjustment which deals with the renewal and interpretation of the Operating Agreement between the New York Central Railroad Company and the Peoria and Eastern Railway Company and the prejudice resulting therefrom to the Income Bondholders. Therefore, petitioners deem it necessary to print only such portions of the proceedings and exhibits introduced in the District Court as are pertinent to the foregoing questions.

5. The First Mortgage Bondholders' Protective Committee has set forth in its motion the unsuccessful efforts made with counsel to the Peoria and Eastern Railway Company

to stipulate for the diminution of the record, in which efforts counsel to the petitioners herein participated. The motion made on behalf of the First Mortgage Bondholders' Protective Committee sets forth the documents and exhibits which are necessary to be included in the printed record. The documents and exhibits therein listed include those portions of the record necessary for a consideration of the questions presented in the petition for a writ of certiorari herein.

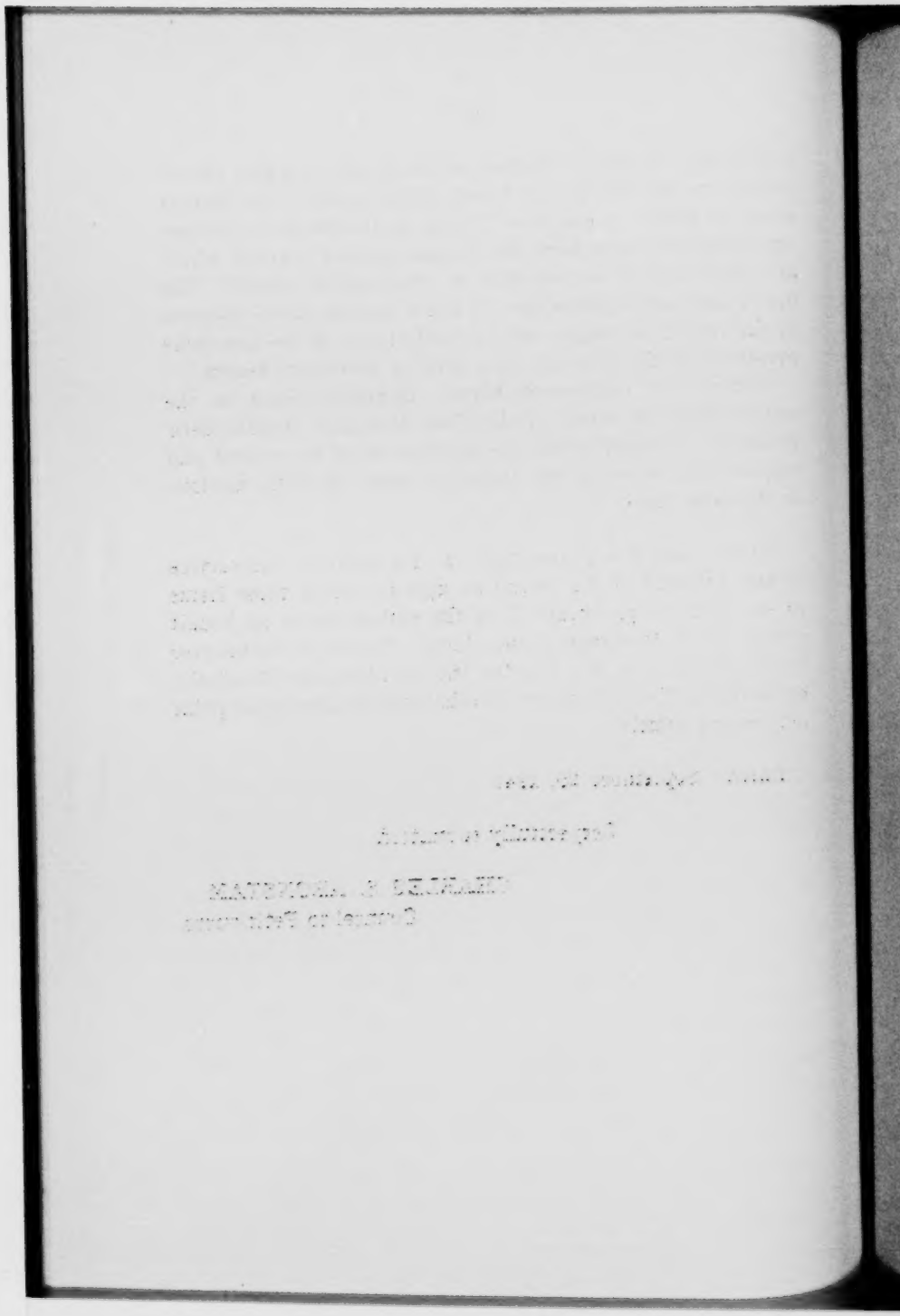
Counsel for petitioners herein, therefore, joins in the motion made on behalf of the First Mortgage Bondholders' Protective Committee for the diminution of the record and respectfully requests the Court to refer to both motions at the same time.

WHEREFORE, it is prayed that (a) the printing and service of any portions of the record on appeal, except those items as set forth in paragraph 7 of the motion made on behalf of the First Mortgage Bondholders' Protective Committee be dispensed with, and (b) the Income Mortgage Bondholders and the First Mortgage Bondholders be allowed to print one record jointly.

Dated: September 25, 1940.

Respectfully submitted,

CHARLES S. ARONSTAM,
Counsel to Petitioners.



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IN THE

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OCTOBER TERM, 1940.

No. 467.

WM. CARNEGIE EWEN, LEWIS L. CLARKE, M. D. ADAMS and GEORGE E. WILE, as members of a duly constituted Income Bondholders' Protective Committee,

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against

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Respondents.

REPLY BRIEF OF PETITIONERS IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI, AND ANSWER IN SUPPORT OF MOTION FOR DIMINUTION OF RECORD.

CHARLES S. ARONSTAM,
Counsel to Petitioners.

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Section 725 (Title II, U. S. C. A., §1225).....

TREATISE CITED

Williston, Contracts, Rev. Ed., Vol. 3, §623.....

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Respondents.

REPLY BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

Preliminary Statement.

The brief presented on behalf of The Peoria and Eastern Railway Company, hereinafter referred to as the Respondent or the Peoria Company, presents an exclusively *laissez-faire* argument in opposition to the petition for a writ of

certiorari submitted on behalf of the Income Bondholders. It ignores entirely the rights and equities of the Income Bondholders who are adversely affected by the renewal of the Operating Agreement in the manner proposed in the Plan of Adjustment in that, by reason thereof, the Income Bondholders will be precluded from receiving any interest on their bonds for the next twenty years, the extended period of said Operating Agreement.

Although the brief is presented ostensibly on behalf of the Peoria Company, the arguments advanced are solely for the benefit of the New York Central and the Big Four. Therefore in this reply brief whenever reference is made to the Respondent it is intended to refer to the New York Central and the Big Four rather than to the Peoria Company *which is not independently represented in these proceedings.*

At the outset of its brief Respondent states that the United States Supreme Court has refused certiorari in the only other cases where review was sought under Chapter XV of the Bankruptcy Act: *Getz* v. *Baltimore & Ohio R. Co.,* 309 U. S. 654, 697; *Steelman* v. *Wichita Falls & S. R. Co.,* 309 U. S. 687, 84 L. Ed. 906.

The basic issue presented in both of the aforesaid cases was that bondholders who assented to the plan of adjustment prior to the filing of the petition for approval thereof occupied a class distinct from that of the non-assenters and therefore it was necessary to secure consents from the non-assenters as a class separate and apart from the class of assenters. None of the issues raised in the instant case were presented in the petitions in the aforesaid cases. Consequently the decisions in these cases are not applicable herein and can have no bearing on the merits of the petition for writ of certiorari in the instant case.

The Big Four—A Third Party.

The Respondent in its brief attempts to convey to this Court that, insofar as the Plan of Adjustment is concerned, the Big Four was a *disinterested* third party and the Peoria Company had to bargain with the Big Four to vote its stock in favor of the Plan, to extend the Operating Agreement, and to pay the Purchase Money Lien on the Springfield Division provided the Plan became effective.

Respondent glosses over the fact that the Peoria Company is a wholly controlled subsidiary of the Big Four, which company in turn is a wholly controlled subsidiary of the New York Central. The three companies have common officers, directors, counsel and operating executives. In truth and in fact the Big Four and the Peoria Company are nothing more than instrumentalities of the New York Central. The Plan of Adjustment was promulgated by the New York Central through its instrumentalities, the Big Four and the Peoria Company, and the evidence adduced at the hearings clearly shows that there was no one representing the Peoria Company who could object to the right of the Big Four to renew the Operating Agreement. There was no one representing the Peoria Company to scrutinize the fairness and equitableness of the terms and conditions of the renewal. There were in fact no negotiations conducted at arms' length as to any of the terms and provisions in the Plan of Adjustment in which the interests of the companies were in conflict.

The vice of the entire situation is in the fact that the officers and directors of the New York Central, the Big Four and the Peoria Company, who are one and the same, have attempted to serve two masters with conflicting interests.

Inter-company Accounts.

The explanation of the Respondent that the reductions of the Peoria Company's indebtedness to the Big Four from 1919 to 1933 "is made up for the most part of re-audits" is contrary to the record facts and lacks plausibility. In 1920 Mr. Wm. A. C. Ewen, as Chairman of an Income Bondholders' Protective Committee, succeeded in reducing the indebtedness of the Peoria Company to the Big Four from $324,286.02 to $24,912.65 (Exhibits V, W). Thereafter Mr. Ewen became a director and Vice-President of the Peoria Company representing the Income Bondholders, and, through his efforts, the Peoria Company succeeded in recovering $755,629.88 which the Big Four had charged against it erroneously (Exhibit X). Mr. Ewen's letter to the President of the New York Central (Exhibit Y) dated February 24, 1933, written while he was still Vice-President, completely refutes the specious contention of Respondent that these reductions were made in the ordinary course of business and clearly shows the dual and conflicting relationship existing between the companies. The following excerpts from Mr. Ewen's letter are pertinent to the inquiry herein:

> "This is an extraordinary situation—an anomaly—virtually a dual management, and was put into effect after an investigation by me of the affairs, in 1919, of the P. & E. that had resulted in the recovery of some $350,000 from the 'Big Four', mostly due to irregularities and partly due to the operation of the so-called Operating Contract of 1890. An iniquitous contract that had been imposed upon the newly created Peoria and Eastern * * * a contract that, among other things, was never submitted to the Minority Stockholders for approval and ratification. The 'Big Four' thru its President, the late Melville E. Ingalls, created a stock capitalization for the P. & E. of $10,000,000 * * * It (the Big Four) took $5,000,000 of the $10,000,000 stock without paying any cash consideration for it, and then it ac-

quired one share (par value $100) for cash that gave the 'Big Four' a majority of the stock to vote and control the P. & E. It elected all the directors —according to my best information and belief, dummies—who voted and by their action executed and put into effect the Operating Contract, that is placed the P. & E. in bondage. * * *

* * * * * * *

"From 1925 to 1932, I have from my own individual work and investigations * * * recovered and got credit for the P. & E. a sum aggregating $755,629.00. This is confirmed by the 'Big Four' and the P. & E. books."

Except for Mr. Ewen there never was a time when there was anyone to supervise the inter-company accounts or to negotiate with respect to the allocation of the various credits and charges between the companies.

Right of Election of the Big Four to Renew Operating Agreement.

Respondent does not cite one case in support of its contention that the Big Four had the right to renew the Operating Agreement for twenty years under the provision contained therein "for such further time thereafter as it may elect."

Respondent fails to advise this Court that recently the case of *Hoff* v. *Royal Metal Furniture Co.*, 117 App. Div. 884, was distinguished from *Western Transportation Co.* v. *Lansing*, 49 N. Y. 499, and the doctrine of the latter case reaffirmed in *Gaswell Service, Inc.* v. *Sinclair Refining Co.*, 240 App. Div. 240, aff'd 266 N. Y. 539, wherein the Court said:

> "We are of opinion, therefore, that defendant's continuance after the date of its leases was at will and terminable when the defendant vacated; and that there was such indefiniteness of term as to render the lease void for uncertainty. (*Western*

Transportation Co. v. *Lansing*, 49 N. Y. 499; Jones Landl. & Ten., §112, p. 137.) *The leases in Hoff* v. *Royal Metal Furniture Co.* (117 App. Div. 884) *and Burns* v. *City of New York* (213 N. Y. 516) *contain provisions for fixed, definite renewals, and thus presented covenants that were in no way indefinite*" (p. 241).

The other cases cited by Respondent have no application to the instant case. In these cases the Court had before it the construction of an option to renew a lease which contained the choice of several specified periods. In none of these cases was the period of renewal left uncertain and indefinite, with the lessee retaining the unlimited right to decide at a subsequent date the nature and extent of his performance. The fact that the Special Court was not able, as it stated in its opinion, to find any pertinent decisions in Illinois and Indiana, where the railroad is located, was no reason for it to disregard the law as enunciated in the cases cited in the brief of the Income Bondholders in the lower court and in the brief in support of their petition for writ of certiorari.

The argument advanced by Respondent that, assuming the expiration of the Operating Agreement at this time, the advances made by the New York Central and the Big Four would continue as a liability of the Peoria Company distorts the clear and unambiguous language in the Operating Agreement which provides that the Big Four "shall and will look only to such future net earnings of said lines of railroad operated by it * * * for reimbursement to it of any sums it may advance." Paragraphs Third and Seventh of the Operating Agreement clearly shows that it was the intention of the parties that advances were to be repaid only out of future earnings during the life of the contract (Exhibit 26). At the hearings before the Interstate Commerce Commission counsel for Respondent virtually conceded that, if the Operating Agreement is ended, the inter-company debts are extinguished. He stated: "In any event, it serves as, undoubtedly, an addi-

tional reason why we think that this arrangement should be continued for a further period of time, because in that respect it will offer the New York Central an opportunity, if the earnings permit, to retain repayment of all or portion of that indebtedness that might otherwise be doubtful." The Special Court recognized the soundness of the Income Bondholders' contention when it stated in its opinion: "It is true that by so doing the New York Central will be able to recoup for its past advances out of future income, a privilege which would have otherwise ended on April 1, 1940."

Nor can it be validly said that such a result is inequitable to the Big Four. The Big Four created this debt itself and agreed to recoup its advances only out of the net earnings of the Peoria Company created by its operations. To hold the Respondent liable for this debt after the expiration of the Operating Agreement would be a most inequitable result to the Income Bondholders who would be burdened with an obligation created by the parent company without let or hindrance on the part of the subsidiary company.

The Big Four did not have the right to charge Respondent for monies expended for the maintenance and operation of its properties in excess of its net earnings.

Respondent's contention that the Big Four had the right to charge the Peoria Company for monies expended for its maintenance and operations has no legal basis in fact and in law.

1. Under the provisions of the Operating Agreement the advances became extinguished with the termination of the Operating Agreement which expired by its terms on April 1, 1940.

2. Under the provisions of the Operating Agreement the Big Four undertook "at its own cost and expense"

to maintain and operate Respondent's properties and to hold the Respondent free and harmless from any liability therefor. The provisions of the Agreement entered into between the Reorganization Committee of the Ohio Company and the Big Four (Exhibit S) conclusively refutes Respondent's strained and self-interested interpretation of the Operating Agreement. The provisions of the Income Mortgage have no relevancy to the propriety of the Big Four charges as the rights and obligations of the Big Four are controlled entirely by the provisions of the Operating Agreement. The right of the Income Bondholders to the payment of interest is also controlled entirely by the provisions of the Operating Agreement during its existence and not by the provisions of the Income Mortgage.

3. The charges are of doubtful origin as is indicated by the letter of Mr. Wm. A. C. Ewen (Exhibit Y) and were created by the Big Four without any independent supervision by reason of its unrestricted control and domination of Respondent.

The contention of the Income Bondholders that under the Operating Agreement the Big Four cannot charge for monies expended to maintain the Peoria Company's properties in excess of the net earnings is in accord with the interpretation of the Agreement by the President of the Big Four to his Board of Directors three days after its execution (Exhibit O).

Williston on Contracts, Rev. Ed., Vol. 3, states as follows:

> "§623. The interpretation given by the parties themselves to the contract as shown by their acts will be adopted by the Court, and to this end not only the acts but the declarations of the parties may be considered."

Respondent dismisses the President's statement as "a mere informal generalization of the total obligation of the

Big Four." The President's interpretation of the Operating Agreement, that the Big Four had taken over the operation of Respondent's properties at a net rental of $412,200, precludes any hypothesis that there could be a deficit chargeable to the Peoria Company on account of maintenance and operating expenses.

The Income Bondholders are adversely affected by the Plan of Adjustment and their written consents should have been secured.

The Income Bondholders do not object to the distribution of the $5,000,000, the proceeds from the Purchase Money Lien, to prior lienors and do not contend that they are adversely affected thereby. The Income Bondholders contend that the renewal of the Operating Agreement in the manner proposed in the Plan of Adjustment adversely affects their interests for the reasons set forth under Point D of their brief in support of their petition for a writ of certiorari, and by reason thereof their written consents should have been secured in the manner provided in Sections 710 and 725 of Chapter XV. Respondent wholly fails to make any answer to this contention in its brief.

The writ of certiorari to the United States District Court for the Southern District of New York should be granted.

Dated: New York, New York, October 22, 1940.

Respectfully submitted,

CHARLES S. ARONSTAM,
Counsel to Petitioners.

CHARLES S. ARONSTAM,
ARCHIE S. KARP,
of Counsel.

Answer to reply of Respondent The Peoria and Eastern Railway Company to petitioners' motion for diminution of record.

Since the Respondent has made no objection to petitioners' motion for the printing of a joint record with the First Mortgage Bondholders' Protective Committee (No. 466), petitioners respectfully request that the answer of said Committee to the reply of The Peoria and Eastern Railway Company to the motion for the diminution of the record be deemed the answer of the petitioners herein.

Dated: New York, New York, October 22, 1940.

Respectfully submitted,

CHARLES S. ARONSTAM,
Counsel to Petitioners.

Office - Supreme Court, U. S.
FILED
OCT 16 1940
CHARLES ELMORE CROPLEY
CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1940.

No. 466.

DONALD N. GILBERT *et al.*,
Petitioners,
against
THE PEORIA AND EASTERN RAILWAY COMPANY *et al.*,
Respondents.

No. 467.

WILLIAM CARNEGIE EWEN *et al.*,
Petitioners,
against
THE PEORIA AND EASTERN RAILWAY COMPANY *et al.*,
Respondents.

BRIEF OF RESPONDENT, THE PEORIA AND EASTERN RAILWAY COMPANY, IN OPPOSITION TO PETITIONS FOR WRIT OF CERTIORARI, AND REPLY TO MOTIONS FOR DIMINUTION OF RECORD.

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against
THE PEORIA AND EASTERN RAILWAY COMPANY *et al.*,
Respondents.

BRIEF OF RESPONDENT, THE PEORIA AND EASTERN RAILWAY COMPANY, IN OPPOSITION TO PETITIONS FOR WRIT OF CERTIORARI.

Preliminary Statement.

The proceedings below were had pursuant to Chapter XV of the Bankruptcy Act (Sections 700-755) for an ad-

justment of debt of The Peoria and Eastern Railway Company, herein called the Peoria and Eastern. That Chapter invests the Court with jurisdiction in respect of "postponements or modifications of debt, interest, rent, and maturities or for modifications of the securities or capital structures of railroads" (Sec. 700). Abundant safeguards for the protection of the rights of all concerned, including such security holders as the present petitioners, have been provided by the statute and were observed in this case. Before the proceeding may be instituted in Court, the Interstate Commerce Commission must authorize the issuance or modification of securities contemplated by the plan of adjustment. The Commission is specifically required to "scrutinize the facts independently of the extent of acceptances of such plan and of any lack of opposition thereto" and approval may only be granted on the basis of specific findings by the Commission that the adjustment, among other things, is in the public interest and the best interests of each class of creditors and stockholders, is feasible and financially advisable (Sec. 710). Following hearing and extensive evidence, the Commission rendered its unanimous Report and Order of approval (Exhibit 30). Thereafter, not less than the required two-thirds in amount of the affected security holders having assented to the Plan, proceedings for approval and authorization were had before a Special Court composed of Circuit Judge Learned Hand and District Judges John M. Woolsey and Murray Hulbert. As in the proceeding before the Commission, so also in the court proceeding, the statute makes meticulous provision for safeguarding the rights of all security holders. Here, also, specific findings by the three-judge Court are required as a condition to approval of the

Plan (Sec. 725). After full hearings and a complete record (more than three-fourths in amount of the affected security holders having assented), the Court made its detailed findings and entered its enabling decree. In the only other instances where review of cases under this Chapter of the Bankruptcy Act has been sought, petitions for certiorari have been denied. (*Getz* v. *Baltimore & Ohio R. Co.*—Certiorari denied January 29, 1940, 309 U. S. 654; Re-hearing denied March 25, 1940, *ibid.* 697. *Steelman* v. *Wichita Falls & S. R. Co.*—Certiorari denied April 22, 1940, 309 U. S. 687; Re-hearing denied May 20, 1940, 84 L. Ed. 906.) The statute was temporary in nature and expired, except as to proceedings previously initiated, on July 31, 1940 (Sec. 755). There is, therefore, no suggestion that the disposition of this proceeding will affect other contemporaneous or prospective cases.

Although we feel constrained to discuss the questions raised by petitioners, it is submitted that none of the questions so presented, nor the case itself, is of a character warranting review by the Supreme Court.

Historical Background.

The Peoria and Eastern is an Illinois corporation which, pursuant to a Reorganization Agreement, acquired from the purchasers in foreclosure proceedings, by deed dated February 22, 1890, that part of the former Ohio, Indiana and Western Railway extending from Pekin, Illinois, to Indianapolis, Indiana, a distance of 201.53 miles, the part from Pekin to the Illinois-Indiana boundary line (conveyed in fee) being called therein the Illinois part and the part from the Illinois-Indiana line to Indianapolis (leased in perpetuity) being called therein the Indiana part. The

deed was made subject to two underlying mortgages securing prior bonds, viz.: (1) $1,000,000 of 7% Indiana, Bloomington and Western Railway Company Bonds, herein called I. B. & W. Bonds, due January 1, 1900, which were subsequently extended to April 1, 1940 with interest at 4% per annum, and (2) $500,000 of 5% Ohio, Indiana and Western Railway Company Preferred Bonds, herein called O. I. & W. Bonds, due April 1, 1938 (Findings 1, 3, 5 and 7).

That part of the former Ohio, Indiana and Western Railway extending from Indianapolis, Indiana, to Springfield, Ohio, called the Springfield Division, was conveyed by the purchasers in the foreclosure proceedings, by deed dated February 22, 1890, to The Cleveland, Cincinnati, Chicago and St. Louis Railway Company, herein called the Big Four, reserving a Purchase Money Lien thereon for $5,000,000 which, if not previously paid, was to become enforceable by foreclosure or otherwise on April 1, 1940. The Big Four was not obligated to pay the principal but was obligated to pay as interest the net earnings of the property up to 4% per annum upon said $5,000,000 (Finding 6).

Pursuant to said Reorganization Agreement, the Peoria and Eastern also executed its Consolidated Mortgage dated February 22, 1890, to secure $10,000,000 of its 4% Consolidated Bonds due April 1, 1940, of which $7,930,000 were to be issued at that time and $1,500,000 were reserved for issue in exchange for the prior lien bonds. The mortgage covered the Peoria and Eastern Railway, subject to the prior lien bonds, and there was pledged thereunder the $5,000,000 Purchase Money Lien on the Springfield Division (Finding 8).

Pursuant to said Reorganization Agreement, the Peoria and Eastern also executed its Income Mortgage

dated February 22, 1890, securing $4,000,000 of its Income Bonds due April 1, 1990, bearing interest at a rate not in excess of 4% per annum, but payable only out of the net earnings and income of the property as provided in the mortgage (p. 27, this brief). The mortgage covered the same property as the Consolidated Mortgage, subject to the prior lien bonds and the Consolidated Bonds, and was subject to the Operating Agreement and Supplement thereto hereinafter referred to (Finding 11).

Also, pursuant to the Reorganization Agreement, an Operating Agreement, dated February 22, 1890, was entered into between the Peoria and Eastern and the Big Four. In view of the fact that the principal contentions of petitioners, interveners below, are predicated on misapprehension of the Operating Agreement, a statement of its provisions is here given:

> First*—The Peoria and Eastern grants to the Big Four, subject to the mortgages securing the Consolidated Bonds, the right to use and operate the Illinois part and assigns its leasehold interest in the Indiana part of the Peoria and Eastern Railway, together with its rolling stock and equipment (to be considered as included in the Indiana part) and the Big Four agrees during a period of fifty years from April 1, 1890 *and for such further time thereafter as it may elect,* to use and operate said Railway providing at its expense all other rolling stock and equipment, labor and supplies necessary for that purpose and in general complying with all obligations upon the Peoria and Eastern with respect to its maintenance and operation.
>
> Second—The Big Four covenants to make good any deficiency which may at any time occur in the

* Paragraph references are to the articles of the Operating Agreement (Exhibit 26).

fund necessary for the due and punctual payment as it accrues of the interest on the two series of prior bonds (I. B. & W. Bonds and O. I. & W. Bonds) and of the interest on the Consolidated Bonds, after devoting to such interest payment the net income from the Purchase Money Lien of $5,000,000 on the Springfield Division and the net earnings derived from the Indiana part and the net earnings derived from the Illinois part of the Railway and the Big Four guarantees that the net earnings and income from said three sources *so actually applied to the payment of interest* should not be less than $412,200* in each and every year of the fifty years for which it undertook the use and occupation of said Railway, such guarantee to be increased in the sum of $40 for each $1,000 of Consolidated Bonds issued in excess of $9,430,000, and with the authority to the Peoria and Eastern to assign the covenants contained in such second clause to the Trustees of the mortgage securing the Consolidated Bonds, and then such covenants were to be deemed a direct guarantee by the Big Four of the payment of interest on said bonds and on said prior mortgage bonds.

Third—The Big Four was to receive all earnings and income from the use and operation of the Railway and of the rolling stock and equipment and was to apply the net earnings of each year arising from the same "(to be ascertained by deducting from the earnings and income of the year from its use and operation of said 'Illlinois part' and said 'Indiana part', the expenses of operation and maintenance during such

*7% interest on $1,000,000 I. B. & W. Bonds, 5% interest on $500,000 O. I. & W. Bonds and 4% interest on the then outstanding $7,930,000 of Consolidated Bonds equal $412,200. At time of extension, in 1900, of the I. B. & W. Bonds, the interest rate was reduced to 4%, and ever since that time the figure of $412,200 has had only historical interest (Finding 5(a)).

year, including taxes, assessments, insurance, rental and other like charges, and the cost of repairs, renewals and reasonable betterments to the said 'Illinois part' and the said 'Indiana part', necessary for their economical and efficient operation)", together with the net income from the Purchase Money Lien on the Springfield Division, to the payment of the interest upon the two series of prior bonds (I. B. & W. Bonds and O. I. & W. Bonds) and to the payment of interest upon the Consolidated Bonds. After reimbursing itself out of what should remain of such net earnings and income not applied to the payment of interest for any advances under the agreement in any previous year remaining unpaid to it (with interest at 6% per annum), the Big Four was to apply the balance of said net earnings and income to the payment of interest on the Income Bonds according to the requirements of the mortgage securing such bonds and pay over to the Peoria and Eastern any amount remaining. The Big Four was to be entitled to make the customary charge for the use of any and all additional rolling stock and equipment furnished by it as theretofore provided for use on said lines of railroad, such charge to be included in the expense of operation.

Fourth—The Big Four was, within sixty days after December 31, 1890 and each year thereafter, to render an account to the Peoria and Eastern of its operations under the agreement and also was to render proper accounts to the Trustees under the Income Mortgage.

Fifth—The Big Four was to look only to such future net earnings of said lines of railroad operated by it under the Operating Agreement and such future income of such Purchase Money Lien as should not be required for the payment of interest on the prior bonds and on the Consolidated Bonds for the reimbursement to it of any sums it might advance in compliance with

its aforesaid agreements, and the Peoria and Eastern charged all such future net earnings and income not required for the payment of such interest with the payment of all such advances to the Big Four with interest at 6%.

Sixth—The Peoria and Eastern was to permit the Big Four to use its name in the operation of said railroad.

Seventh—Upon default, the Peoria and Eastern might resume operation without affecting the interest guaranty by the Big Four. All property acquired through earnings of the Peoria and Eastern was to become its property, and upon termination of the contract the Big Four was to restore to the Peoria and Eastern appropriate rolling stock and equipment at least equal in value to the rolling stock and equipment received.

By the Supplement to the Operating Agreement of even date therewith, all sums paid out by the Big Four for interest over and above the net earnings as defined in Article Third of the Operating Agreement and net income from the Purchase Money Lien were to be deemed advances by the Big Four under Article Fifth of the Operating Agreement against all parties save the Consolidated Bondholders and the Trustees under the mortgage securing such bonds (Exhibit 27).

Plan of Adjustment.

At the time of the preparation of the Plan of Adjustment dated January 10, 1940, the Peoria and Eastern faced the maturity on April 1, 1940, of the following outstanding securities (Finding 31):

$846,000, principal amount, of I. B. & W. Bonds outstanding in the hands of the public (exclusive of $154,000, principal amount, of such bonds held in a sinking fund for such bonds);

$8,376,000, principal amount, of Consolidated Bonds in the hands of the public (exclusive of $124,000, principal amount, of such bonds held in the sinking fund for the I. B. & W. Bonds); and

$500,000, principal amount, of indebtedness incurred to provide for the payment of the O. I. & W. Bonds on April 1, 1938, evidenced by note of the Peoria and Eastern in that amount secured by $500,000, principal amount, of Consolidated Bonds and by 1730 shares of stock of the Peoria and Pekin Union Railway Company of the par value of $173,000.

In addition to the above maturities:

The term of the Operating Agreement would expire on April 1, 1940, unless extended.

The $5,000,000 Purchase Money Lien on the Springfield Division would become enforceable on April 1, 1940.

The charter of the Peoria and Eastern would expire, unless extended, on February 20, 1940, and to effect an extension under the Illinois statute, in addition to a three-fourths stock vote, the stockholders desiring renewal were required to agree to purchase at its current value the stock of those opposed.

In aid of the proposed Plan of Adjustment, the Big Four agreed to vote its holdings of stock in favor of the extension of the charter of the Peoria and Eastern and to make the required agreement to purchase the stock of opposing stockholders and, subject to the Plan becoming effective, to pay the Purchase Money Lien on the Springfield Division.

The Plan provides that:

Out of the $5,000,000 so to be paid by the Big Four:

$846,000 is to be applied to payment in full of the prior I. B. & W. Bonds;

$384,500 is to be applied on account of the Consolidated Bonds pledged for the indebtedness of $500,000 incurred in connection with the payment of the O. I. & W. Bonds on April 1, 1938, and The Securities Corporation of the New York Central Railroad is to accept such payment and $115,500 of reduced principal amount of such Consolidated Bonds (to be extended for twenty years with interest at 4%) in satisfaction of the indebtedness and is to surrender the stock of the Peoria and Pekin Union Railway Company of the par value of $173,000 pledged as security;

$3,769,200 is to be paid ratably on account of the principal of the remaining $8,376,000, principal amount, of outstanding Consolidated Bonds, being at the rate of $450 for each $1,000 Bond, and the reduced principal amount is to be extended for twenty years with interest at 4%;

$300 is to be used by the Trustee in the purchase of the reduced and extended Consolidated Bonds.

The Operating Agreement is to be extended for an additional term of twenty years, carrying with it the obligation upon the Big Four during such extended term to operate the property, to assure the costs of maintenance and operation, taxes and reasonable betterments and to pay the interest on the Consolidated Bonds (the prior bonds being paid).

The 1730 shares of stock of the Peoria and Pekin Union Railway Company, having a par value of $173,000, are to be pledged as additional security under the mortgage securing the Consolidated Bonds, and the $154,000 of I. B. & W. Bonds and $124,000 of Consoli-

dated Bonds held in the sinking fund for the I. B. & W. Bonds are to be surrendered.

The advances made by the Big Four and New York Central under the Operating Agreement are to continue their existing status under such agreement.

The Income Mortgage Bonds are to continue their existing status.

The moneys held by the New York Central for the Peoria and Eastern in an equipment retirement account and future accretions to such account are to be applied currently in the acquisition of equipment.

Proceedings in Special Court.

Gilbert et al., petitioners in No. 466, intervened in the Court below, alleging that they had constituted themselves as a Committee of Consolidated Bondholders and that they represented holdings which aggregated about 6% of the outstanding issue of said Consolidated Bonds.

Ewen et al., petitioners in No. 467, also intervened in the Court below, upon an allegation that they represented holdings of Income Bonds aggregating approximately 7½% of the outstanding issue of said Income Bonds.

The contentions now made by petitioners were urged before the three-judge Court but were overruled as indicated in the opinion that was filed and in the findings and decree that approved the Plan, with a slight modification not here material.

Comments on Certain Statements in the Petitions.

Before passing to a discussion of the reasons advanced by petitioners in support of their applications, it is appropriate to comment on certain matters referred to on pages

8-15 of the petition of the Gilbert Committee and on pages 3-9 of the petition of the Ewen Committee.

(1) Gilbert Committee brief.

The valuation shown at page 8 is the valuation of the Commission for rate-making purposes. The book value is greater. Such valuation, however, shows total assets of $12,337,133 against fixed interest mortgage bonds outstanding after consummation of the Plan of $4,722,300. Other indebtedness amounts to $6,485,482. This leaves, on such basis, a value in excess of $1,000,000 for the capital stock.

At page 9 there is reference to the fact that during the ten years ending with 1939 (assuming the Purchase Money Lien to have been paid) the average annual earnings would have amounted only to $170,301 per year, while the interest on the Consolidated Bonds, after the consummation of the Plan, will amount to $188,892. These have been years of great depression in the railroad industry and as far as the Consolidated Bondholders are concerned the interest on such bonds will, under the Plan, be guaranteed by the Big Four or New York Central, lessee, for the next twenty years.

At page 10 the comment relates to the instrumentality rule. The Reorganization Agreement of the Ohio, Indiana and Western Railway in 1889 followed protracted negotiations between the O. I. & W. Reorganization Committee and a Committee of the Big Four (Exhibits K to Q, and S), and the issue of one-half of the capital stock of the Peoria and Eastern to the Big Four was in consideration of the various agreements made by the Big Four in connection with that reorganization. These exhibits clearly indicate that the 1889 Reorganization Agreement was negotiated by per-

sons dealing at arm's length and negative any suggestion of domination by the Big Four in the formulation of the Operating Agreement, the Consolidated Mortgage, the Income Mortgage and the other instruments by which such reorganization was accomplished and the rights of the parties concerned in the present Plan of Adjustment are defined.

Under the instrumentality rule any contract between a controlling and controlled company is, of course, subject to careful scrutiny. Such rule, however, does not mean that an agreement which is fair and of advantage to the controlled company is to be condemned merely because of such control. The proposed Plan of Adjustment and the extension of the Operating Agreement were approved by the affirmative vote of 73,694 shares of stock of the Peoria and Eastern, with only 20 shares voting in opposition (Exhibit 4).

The so-called "accumulation of operating deficits" commented upon (p. 10) are made up of $1,806,493 for additions and betterments made to the Peoria and Eastern property, $105,667 for retiring prior I. B. & W. Bonds, $54,651 for the purchase of 480 shares of stock of the Peoria and Pekin Union Railway Company, and the balance for certain miscellaneous items and accrued interest (Exhibit I). The matter of the divisions of rates was considered by the Interstate Commerce Commission. No suggestion has been made that the divisions are not fair or do not accord with the usual arrangement. The implication in the statement that the Big Four reduced its charges in 1919 from $324,286 to $24,912 is a caricature of the facts. Exhibit V sets forth the settlement then made. The reversal of charges claimed in Exhibit Y is made up for the most part of re-audits of

freight accounts made by the Peoria and Eastern auditor (Exhibit X). Such accounts are subject to re-audit between railroads continuously as more detailed information regarding shipments becomes available. The accounts of the Peoria and Eastern are subject at all times to the supervision of the Commission.

In addition, the Income Mortgage (Article Sixth) provides for filing each year of full accounts and for inspection of the books by an officer of the corporate trustee or by an expert accountant whose services are required to be paid for by the Peoria and Eastern. Such accounts have been filed regularly each year (Exhibit 51).

During the period from 1920 to 1930 railroads generally required substantial expenditures for betterments to enable them to operate with heavier power. This meant the laying of heavier rail, the strengthening of bridges, and signal and other changes necessary in connection therewith. Exhibit 36 which covers the period 1923-1939 shows that the account was largely made up of such items. This cost was advanced by the Big Four and, to the extent not repaid, is reflected in the present account. The Consolidated Mortgage by reason of such expenditures is now a lien upon a modern railroad plant.

Comment is made, at pages 11-15, on the equipment account, the status of equipment under the Consolidated Mortgage and alleged diversion of the mortgage estate.

Under the Operating Agreement the rolling stock and equipment of the Peoria and Eastern were included as part of the Indiana part. Articles First and Third of said agreement provided for the maintenance, renewal and replacement of the existing equipment and the furnishing by the Big Four, at the usual *per diem* charges, of all additional

equipment required in excess of the Peoria and Eastern's owned equipment; and Article Seventh of said agreement provided for the turning over at the termination of said agreement of equipment of equal value to that received.

Under the regulations of the Commission, in order that each year may properly reflect the expenses of such year, there is charged upon the books of railroad companies against the revenues of that year a sufficient percentage of the original cost of equipment to aggregate, at the expiration of its assumed life, such cost. Under the regulations of the Commission, when equipment is retired, the cost thereof is charged against the depreciation account; and in the present case, in order to show the amount of equipment retired and not replaced, such amount is transferred from the depreciation account to a retirement account and, as equipment is replaced, the cost of the replacement is charged against the retirement account. The retirement account of the Peoria and Eastern thus represents the original cost of equipment retired and not replaced, while the depreciation account represents the aggregate of the annual book charges against operating revenues on account of the loss of service life of equipment still in existence (Minutes, p. 209).

The Big Four does not, under the Operating Agreement, owe the Peoria and Eastern at this time the amounts in the depreciation account and retirement account, but it is obligated to keep up the equipment and at the termination of the agreement to turn over to the Peoria and Eastern equipment of a value equal to that of the equipment received. The suggestion in the Gilbert brief, that the Consolidated Bondholders may be entitled to cash in that amount, only

emphasizes the confusion of counsel in their consideration of the proposed Plan. They seem to have in mind a salvage operation, with no regard to the other security holders, the public, or the contractual situation.

Reference is made at page 13 to the release clause of the Consolidated Mortgage (Paragraph Eighth), which provides that the Trustees may require the deposit of the *proceeds of sale* of property released to be applied in like manner as is provided in respect of proceeds of insurance. Equipment retired is equipment that has become worn out and the service life of which has ended. It is not equipment sold and released.

In passing, it may be said that since the amount shown in the equipment retirement and equipment depreciation accounts represent charges against the operating revenues of the Peoria and Eastern in accordance with the regulations of the Commission, interest at the rate of 6% per annum on said amount is credited currently against the interest on the advances made by the Big Four or New York Central to the Peoria and Eastern under the Operating Agreement.

(2) Ewen Committee brief.

At page 3 the statement is made that the Reorganization Agreement of 1889 was formulated by and under the supervision of the Big Four. Not only does the record fail to support this assertion but, on the contrary, the undisputed evidence definitely negatives the assertion (Exhibits K to Q).

At pages 4 and 5 certain provisions of the Operating Agreement are stated. Such statement does not give an

accurate picture of its terms (as is shown at pages 5-8 of this brief).

At page 5 reference is made to a statement made in February, 1890, by the then President of the Big Four. His generalization does not affect the terms of the agreements actually executed. The sum of $412,200, to which he refers as "net rental", represented the interest on the then outstanding fixed interest bonds as shown above (p. 6).

At page 7 there is the statement that the decision of the Commission approving the applications "was predicated upon the assumption, and so recorded in the decision," that there was no opposition to the Plan of Adjustment and to the renewal of the Operating Agreement. The Commission in its report (Exhibit 29), said:

> "We have scrutinized the facts relative to this application independently of the extent of the acceptance of such plan by the bondholders, and of the lack of any opposition thereto, and conclude that on the record here before us the authorization sought should be granted."

At page 10 reference is made to the Special Court being "influenced in its decision by the threats of the New York Central". There were no such threats. The Court could hardly have passed upon the Plan without taking account of the probable consequences of its rejection.

Reasons Advanced in Gilbert Committee Brief (pp. 19, 20) Do Not Warrant Allowance of Writ.

1.* The *Los Angeles Lumber Company* case (308 U. S. 106) and the *United States Realty and Improvement Company* case (310 U. S. 434) are not applicable to an adjustment such as is here under consideration, because here:

(a) The corporation has been found not to be in need of financial reorganization under Section 77 and its inability to meet its debts matured or about to mature has been found to be temporary only (Findings 44, 45);

(b) The corporation is not insolvent (pages 8 and 9 of Gilbert petition), and the total assets on the basis there shown are more than two and a half times the amount of Consolidated Bonds which will be outstanding if the Plan be consummated, and more than $1,000,000 in excess of the claims of all creditors;

(c) A payment of $450 is made on account of the principal of each $1,000 of Consolidated Bonds and the bonds prior in lien thereto are paid in full;

(d) The stockholders consent to the pledge, as additional security under the Consolidated Mortgage, of shares of stock owned by the Corporation and now unpledged having substantial value and approve the surrender of $154,000 of prior lien bonds and $124,000 of Consolidated Bonds held in the sinking fund for such prior lien bonds;

(e) The majority stockholder under the extension of the Operating Agreement guarantees the payment of maintenance and operating expenses, reasonable betterments and taxes as well as the interest on the reduced principal of the Consolidated Bonds during the extended term of twenty years;

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* Paragraph numbers refer to those shown in Gilbert brief, pp. 19, 20.

(f) There is no scaling down of the claims of creditors and the rights of stockholders continue junior and subordinate to the rights of creditors.

2. Similarly, the *Louisville Trust Company* case (174 U. S. 674) is not applicable to this adjustment. The position of the Consolidated Bonds is strengthened and the payment of interest thereon and of cost of reasonable betterments to the property is assured even though the revenues may at times be less than maintenance and operating expenses, taxes and interest. The rights of the other creditors remain unaffected by the Plan. The record does not show any inequitable conduct.

3. The provisions of Chapter XV of the Bankruptcy Act show it is not a mere moratorium statute, but that it is intended to authorize an adjustment such as has been here provided for. The requirement of Section 710(2)(b), that there must be a finding that the corporation's *inability* to meet its debts is reasonably expected to be temporary only, cannot rationally be construed as a requirement that any *postponement* of maturities under the Plan must be temporary only. The term "adjustment" as defined in Section 705(7) expressly includes a modification of maturities, of securities or capital structures. Section 710(2) requires the order of the Commission under Section 20a of the Interstate Commerce Act "authorizing the issuance or modification of securities as proposed by such plan of adjustment." Section 735 of the Act makes inapplicable certain sections of the Internal Revenue Code "to the issuance, transfer, or exchange of securities or the making or delivery of conveyances to make effective any plan of adjustment confirmed under the provisions of this chapter", and also provides

that no taxable income, gain or profit is to be deemed to have accrued or to be realized by such petitioner "by reason of a modification of or cancelation in whole or in part of any of the indebtedness of the petitioner affected by a proceeding under this chapter".

4. The only creditors affected by the Plan of Adjustment under the definition contained in Section 706 are the Consolidated Bondholders.

The Reorganization Agreement of the Ohio, Indiana and Western Railway (Exhibit S), in accordance with which a 50% stock control of the Peoria and Eastern by the Big Four was acquired in 1890, shows its main purpose to have been the security of the Consolidated Bonds. Such Bonds were to represent, under the exchange provided for, all the First Mortgage Bonds, most of the accrued interest thereon and one-half of the Second Mortgage Bonds of the former company (subject to the prior lien bonds of $1,500,000). The Income Bonds were under the plan to represent the other $1,000,000 of Second Mortgage Bonds, certain accrued interest and about $2,500,000 of the Preferred Stock of the former company. The execution of what is here called the Operating Agreement was also provided for therein, giving assurance not only of the payment of interest, operating and maintenance expenses and taxes, but reasonable betterments as well, and the agreement was one of the conditions pursuant to which both the Consolidated and Income Bonds were issued.

Judicial notice may probably be taken of the fact that during the 1920s most railroads were required to make substantial betterments to permit of the use of heavier power, requiring heavier rail, the strengthening of bridges and

other like changes. Over $1,800,000 of the advances now owing by the Peoria and Eastern to the Big Four or New York Central were made for these purposes (Exhibit I). The Gilbert petition now claims that the Big Four should forego the repayment of the advances made by it pursuant to its covenants under the Operating Agreement and which has provided a modern railroad plant, because of the control which was transferred to the Big Four upon the formation of the Peoria and Eastern as part consideration for the agreements so made. The Operating Agreement provided for its continuance at the election of the Big Four, which elected to extend it. No reason can be suggested, based on the instrumentality rule, under which the Big Four should under such circumstances waive its rights as a creditor. The Plan does not determine the amount of advances made by the Big Four but leaves the parties in this regard unaffected by the Plan.

5. There is no basis for the statement that the Court assumed that there was no alternative between approving the Plan and ordering a strict foreclosure. As a matter of fact the Special Court did prescribe a minor modification, saying in its opinion, "Hence we will modify the plan by virtue of the power given us in Sec. 721 so as to provide that the income bondholders shall have one director upon the board" (See also Finding 51). A plan which for its consummation depends upon the payment by a third party, in this case the Big Four, of the $5,000,000 Purchase Money Lien, which it was not obligated to pay, and the extension of the term of the Operating Agreement with guaranty of the interest on the reduced principal amount of the Consolidated Bonds, which the Big Four was not

obligated to extend or guarantee, does not lend itself to major modifications, without consent of such third party.

With respect to the reference to subdivision (h) of the Assignment of Errors: The Commission's valuation of the Peoria and Eastern property plus additional assets is, as above stated, about two and a half times the principal of the Consolidated Bonds to be extended. The argument that there should be a sinking fund for retirement of the Bonds seems to be grounded, as far as any question of law is involved, upon the claim that an extension of a maturity by a plan under Chapter XV must be a temporary extension only, though the statute does not so provide. It is argued that twenty years is not a temporary extension but can be made so by a sinking fund provision to retire part of the bonds prior to the extended maturity date. In other words, it seems that a twenty-year extension is temporary, or not, according to the amount of bonds affected thereby. The Income Mortgage permits of an extension of the Consolidated Bonds. It does not permit of new charges upon income such as a sinking fund.

With respect to the reference to subdivision (i) of the Assignment of Errors: Under the Plan the equipment as it is replaced will become subject to the lien of the mortgage securing the Consolidated Bonds. The depreciation account represents loss of service life of equipment already in existence and, with the retirement account, affords an accounting measure of the equipment which the Big Four would need to turn over to the Peoria and Eastern in fulfillment of its covenant in Article Seventh of the Operating Agreement, were the Operating Agreement immediately to terminate. The retirement account does not represent an amount now due. The Consolidated Bondholders are en-

titled to a lien upon the equipment as replaced. They have no claim upon the account which represents merely the loss of service life of the existing equipment and which account, at the termination of the Operating Agreement, may be greater or less than at present, dependent upon the amount of equipment meanwhile turned over to the Peoria and Eastern.

6. Where the special three-judge Court itself hears and weighs the evidence and makes the findings, we submit that such findings have at least as great weight as where made by the Court upon review of a special master's findings.

Reasons Advanced in Ewen Committee Brief (Points A to F, pp. 16-29) Do Not Warrant Allowance of Writ.

A:* The extension of the Operating Agreement was a matter primarily between the Big Four and the Peoria and Eastern and was approved by an overwhelming vote of the stockholders of the Peoria and Eastern at a meeting called for that purpose with only 20 shares opposing (Exhibit 4). The extension was approved and authorized by the Interstate Commerce Commission under Paragraph (4) of Section 5 of the Interstate Commerce Act (Exhibit 30). The effect of such an order of the Commission has been considered in the following, among other, cases: *Venner* v. *Michigan Central Railroad Company,* 271 U. S. 127; *Lambert Run Coal Co.* v. *B. & O. R. R. Co.,* 258 U. S. 377, and *Illinois Central Railroad Co.* v. *State Public Utilities Commission,* 245 U. S. 493. The authorization and

* Paragraph letters refer to those shown in Ewen brief, pp. 16-29.

approval of the Court were not necessary to the validity of the extension agreement. The guaranty of interest on the Consolidated Bonds and of payment of maintenance and operating expenses, taxes and reasonable betterments to the property was, however, necessarily a part of the Plan were it to be approved by the Consolidated Bondholders. This being so, and the right of the Big Four to elect to extend the Operating Agreement having been challenged, the Special Court had to pass upon that question incident to its consideration of the Plan. Indeed, the extension of the Operating Agreement, with the guaranties therein contained, was obviously vital and necessary to any plan of adjustment.

B: The Ewen brief charges (1) that the Special Court erred in construing the Operating Agreement as authorizing the extension of the term thereof at the election of the Big Four and New York Central and (2) that the Income Bondholders are adversely affected by such extension.

On the first point the main reliance is on the case of *Western Transportation Co.* v. *Lansing* (1872), 49 N. Y. 499. This case was correctly distinguished and held inapplicable, in view of the different circumstances, by the Special Court in its opinion holding that the Big Four had the right at its election prior to the expiration of the term of the Operating Agreement to make the extension. The following decisions in the States where the road is located tend to support the decision of the Special Court: *Anderson* v. *Dodsworth*, 292 Ill. 335; *Falley* v. *Giles*, 29 Ind. 114; and *Hughes* v. *Windpfennig*, 10 Ind. App. 122.

Under the opinion in the *Western Transportation Case*, it is clear that a lease may provide for an extension of the

term at the election of the lessee for a period to be fixed by him, provided the duration of the extension is to be fixed by the lessee at or before the commencement of the extended term. In that case the Court held that the extension provision of the lease there involved did not require the lessee so to fix the term but allowed him to continue on at will after the expiration of the original term and that the provision was, therefore, bad for uncertainty as to duration of the term.

This case was commented upon in *Hoff* v. *Royal Metal Furniture Company,* 117 A. D. 884, affirmed without opinion in 189 N. Y. 555, where the Court had under consideration a covenant for a perpetual yearly renewal of lease, and Gaynor, J., said:

> "The case of *Western Transportation Co.* v. *Lansing* (49 N. Y. 499) is not in point. There the covenant was held to be non-enforceable for uncertainty in respect of the term, and also because the landlord had died. I suppose it is proper to say that the opinion is discursive and has to be read with discrimination. The exact point decided is all that serves as a precedent."

Exhibits 2 and 49 show that the Big Four elected to extend the Agreement for twenty years prior to the expiration of the term. The Income Mortgage was expressly subject to the provisions of the Operating Agreement.

In any event, aside from the right of the Big Four to extend the Operating Agreement, the Income Bondholders are not adversely affected by such extension. The Ewen contention that the Big Four would lose the right to look to future net earnings of the Peoria and Eastern for reimbursement of its advances in the event that the Operating

Agreement were now to terminate is not sustained by the controlling instruments. The wording of Article Fifth of the Operating Agreement, that the Big Four shall look only to the "future net earnings of said lines of railroad operated by it under these presents * * *" for reimbursement of its advances, merely identifies the property to whose future earnings the Big Four may look for its reimbursement. This view is supported by the provision of the Supplement to the Operating Agreement and the provisions of Articles Sixth (p. 27, *infra*) and Fifth of the Income Mortgage and is the fair and reasonable interpretation having regard to the fact that the Operating Agreement is not a lease but an agency contract whereby the Big Four without profit undertook to operate the Peoria and Eastern for account of that company under the terms of the Operating Agreement. To hold that termination of the Operating Agreement automatically effects a forfeiture of advances made for account of the Peoria and Eastern not only involves a strained construction of the words but produces a most inequitable result. The point, however, need not be labored in view of the contractual right to extend the Operating Agreement.

C: The terms of the Operating Agreement are summarized, *supra* (pp. 5-8). The reference in Point C is to Article First under which the Big Four agrees to comply with the obligations of the Peoria and Eastern with respect to the operation and maintenance of the railway. The provisions for meeting expenses and for distribution of the earnings are in Articles Second and Third, and when the three articles are read together it is clear that the construction argued for is untenable. The provision of the Income

Mortgage, relating to the payment of interest, is in Section Sixth, the first paragraph of which is as follows:

> "SIXTH.—That beginning with the year ending December 31, 1890, the Board of Directors of the Railway Company shall ascertain and declare the net earnings and income applicable to the payment of interest upon the bonds secured hereby for the year ending the 31st day of December in each year, by deducting from the gross earnings and income of the Railway Company for such year all interest on prior bonds, and on said First Consolidated Mortgage Bonds, expenses of operation and maintenance, taxes, assessments, insurance, rentals and other like charges, cost of repairs, renewals and reasonable betterments to the property of the Railway Company necessary for its economical and efficient operation, and all deficiencies arising from payments for said purposes in former years not otherwise provided for, and all advances which shall have been made to provide for such deficiencies or any part of them, and shall apply such net earnings and income (or such portion thereof as may be necessary) towards payment of the interest on the bonds hereby secured, in accordance with their terms and the provisions hereof."

The Ewen argument under C is based not only upon a disregard of the provisions of the Operating Agreement but of the provisions of the Income Mortgage as well. The statement made by the President of the Big Four to his Directors some time in 1890 was a mere informal generalization of the total obligation of the Big Four in respect of the prior bonds and Consolidated Bonds. It did not modify the terms of the executed instruments. The guaranty contained in the Operating Agreement and the refer-

ence to the proposed guaranty contained in the agreement with the Reorganization Committee had only to do with the interest on the prior lien bonds and the Consolidated Bonds, which, as shown above, amounted to the sum of $412,200 at the time of the execution of the Operating Agreement.

D: The proceeds of the Purchase Money Lien under the provisions of the Plan are to be applied to the payment of bonds to which the Income Bonds were by the Income Mortgage made expressly subject. The extension of the date of maturity of the Consolidated Bonds was also expressly permitted by the Income Mortgage. No consent or permission was necessary under the Income Mortgage for such application, and such application could have been made with the consent of *all* the Consolidated Bondholders without a Plan. Chapter XV permits such application upon the approval of 75%, instead of all, of the Consolidated Bondholders. In either case the Income Bondholders are not affected. The formula pursuant to which interest becomes payable upon the Income Bonds was not changed by the extension of the Operating Agreement.

E: The statement that the Plan is not fair and equitable as an adjustment is based mainly on the *Los Angeles Lumber Co.* case, which, as discussed above, has no relevancy to the present case. The requirement that a plan be "fair and equitable" does not mean that it may disregard the rights of the various classes of security holders under the instruments defining their respective rights. In the present case the stockholders are making a real contribution to the Plan and their rights remain subordinate to those of the

bondholders. Any question regarding the annual accounting to the Peoria and Eastern and to the Trustees under the Income Mortgage would appear safeguarded by the provision in the Income Mortgage under which, at the request of the Trustee or of the holders of one-fifth of the Income Bonds, the accounts may be subjected to an examination by an expert accountant selected by the Trustee and paid for by the Peoria and Eastern.

F: There were no threats by the New York Central or the Big Four. The Big Four was not obligated to pay the Purchase Money Lien of $5,000,000 upon the Springfield Division, unless it elected to do so. Finding 23 shows that practically 74% of the overhead traffic of the Peoria and Eastern, which overhead traffic constitutes more than 50% of its total traffic, comes to the Peoria and Eastern from the New York Central. The effect of disrupting the existing relationship was patent to the Interstate Commerce Commission and to the Court.

Conclusion.

Wherefore, we respectfully submit that the petitions for writ of certiorari should be denied.

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Counsel for Respondent, The Peoria and Eastern Railway Company.

October 15, 1940.

REPLY OF RESPONDENT, THE PEORIA AND EASTERN RAILWAY COMPANY, TO PETITIONERS' MOTIONS FOR DIMINUTION OF RECORD.

This memorandum deals only with so much of the pending motions as seeks authority to diminish the printed record in event that writ of certiorari is allowed.

In addition to the matter suggested for printing by petitioners (Gilbert motion, pp. 46-48), it is submitted that the following also should be included:

Exhibit 4. Excerpt from minutes of special meeting of stockholders of Peoria and Eastern approving Plan of Adjustment and showing vote by which that approval was had.

Exhibits 18, 19, 24 and K to Q, inclusive, consisting of deed from Coster and Spencer to Big Four covering Springfield Division, deed and lease of Coster and Spencer to Peoria and Eastern, Supplement to Income Mortgage and excerpts from minutes of meetings of Board of Directors of Big Four in 1889 and 1890 (rather than merely an isolated sentence extracted from minutes of one such meeting (Exhibit O) as suggested by petitioners). The printing of these documents is necessary to disprove the unfounded charge (Ewen petition, p. 3) that the reorganization of 1890 was formulated by and under supervision of the Big Four and the repeated suggestion of improper domination supposed to have resulted therefrom. Furthermore, the interrelationship of the Springfield Division purchase money lien and the several classes of securities which emerged from the reorganization of 1890 (prior liens, Consolidated

Mortgage and Income Mortgage) is made clearer by these Exhibits.

Exhibit S. In addition to the first three pages of Exhibit S, desired by petitioners, the first three and one-half pages of agreement between Coster *et al.*, and the bondholders, dated October 30, 1889, is necessary for a full understanding of the arrangement for reorganization therein provided for.

Exhibit V, Memorandum of settlement, dated February 21, 1920; Exhibit X, Statement of re-audits; and Exhibit 51, Annual accounts submitted to Income Bondholders' Trustee, together with testimony of witness Harrigan (Minutes, p. 256). These sharply disprove assertions contained in the petitions and briefs of petitioners with respect to improprieties as to advances to the Peoria and Eastern.

Testimony of witness Boynton S. Voorhees (Minutes, pp. 118-129), which gives a broad description of the Peoria and Eastern, physical and otherwise, and its relationship to New York Central; testimony of witness Willard F. Place (Minutes, page 140 to middle of page 146), which shows how the Plan of Adjustment was formulated; and testimony of witness Edward A. Clancy (Minutes, last line of page 208 and all of page 209 to and including fourth from last line), which explains the retirement and depreciation accounts and answers the misapprehension with respect thereto that is considerably labored in petitions and briefs

of both petitioners. This testimony is short and may be abbreviated by reduction to narrative form.

Respectfully submitted,

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October 15, 1940.